

How Tax Reform Will Impact Nonprofits

By BDO USA, LLP Nonprofit Practice Leaders

On December 20, just a few weeks following the passage of the Senate's Tax Cuts and Jobs Act, both legislative branches passed the conference version of the bill, marking the largest change to U.S. tax policy in decades.

With most of the provisions set to go into effect in the New Year, it's important that nonprofits review the changes that occurred during the conference process to understand the impact to their organizations.

What Changes Are Coming for Nonprofit Organizations?

Reviewing the 1,000-plus pages of the bill is a daunting task for nonprofits.

To help organizations navigate the key provisions affecting nonprofits, we've summarized top considerations and implications below.

Provision	Implications for Nonprofits
<p>Increase the Standard Deduction: The bill nearly doubles the standard deduction for individuals and married couples filing jointly. The increase would be from \$6,350 to \$12,000 for individuals and from \$12,700 to \$24,000 for married couples, adjusted for inflation.</p>	<p>While an increase in the standard deduction benefits taxpayers, many nonprofits fear that it may lead to a reduction in overall giving, as tax filers have less incentive to itemize their deductions—and consequently, less incentive to donate. In fact, the current proposals could lead to a decrease of between \$4.9 and \$13.1 billion in charitable giving, according to a study by the Indiana University Lilly Family School of Philanthropy.</p> <p>One nonprofit wish list item that did not make it to the bill is the idea of a “universal” charitable deduction, which would be available to all taxpayers, whether they itemize or not. This provision, many organizations argue, would not only increase the motivation for people to give, but would send Americans an important overall message on the importance and value of giving.</p>

Increase the Charitable Contribution

Deduction Limit: The bill increases the charitable contribution deduction limit for an individual to 60 percent of his or her adjusted gross income (AGI), up from the current limit of 50 percent.

Repeal the “Pease” Limitation: The bill repeals the “Pease” limitation (named after former Senator Donald Pease), whose original intent was to raise tax revenue by increasing the taxable income for high-income earners. It does this by reducing the value/benefits of several itemized deductions (including charitable contributions) once a taxpayer’s AGI reaches a certain amount (\$261,500 for single filers and \$313,800 for married couples filing jointly). The suspension of this limitation sunsets in 2025.

Tickets to College Athletic Events: The bill repeals the current law that allows a donor who makes a contribution to a college or university and receives priority seating at athletic events in return, to take a charitable contribution deduction of 80 percent of the amount donated.

Impose an Excise Tax on Executive

Compensation: The bill imposes a 21 percent excise tax on the compensation of any covered employee in excess of \$1 million. The term ‘covered employee’ means any employee (including any former employee) of an applicable tax-exempt organization if the employee a) is one of the five highest compensated employees of the organization for the taxable year, or b) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after Dec. 31, 2017. Certain medical professionals are excluded from the definition of a covered employee.

At first glance, an increase in deduction limits appears to be an incentive for high-income donors to give more to charity, as they can claim more of their donations as a charitable deduction.

However, this is unlikely in reality—especially when considering that the population of tax payers who actually *do* give up to 50 percent of their AGI currently is quite small. There may not be many more individuals who would give up to 60 percent of their AGI.

Since the “Pease” limitation reduced the benefits of itemized deductions (including charitable contributions), repealing it allows high earning taxpayers to go back to enjoying the full benefits of these deductions. It is anticipated that this measure could help prompt high earners to donate more to charity.

The new law treats the value of receiving priority seating at athletic events as equivalent to the contribution made and therefore no charitable contribution deduction is allowed.

Tax-exempt organizations will need to factor this new excise tax into their overall tax planning and be aware that this extra payment may require budget cuts elsewhere.

Many questions regarding this provision, however, still need to be addressed. For example, the compensation taken into account includes compensation from related organizations. Would the excise tax be paid by the exempt organization or the related organization? There are many details that still need to be worked out.

Increase the Estate Tax Exemption: The bill doubles the gift and estate tax exemptions from \$5 million to \$10 million (adjusted for inflation) per individual beginning in 2017.

This provision will sunset in 2026, returning the exemptions to their current level.

Impose an 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 US.

Modifications to the Unrelated Business Income Tax (UBIT)

Losses: The bill 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.

Certain Fringe Benefits: Unrelated business income of a tax-exempt organization would include employer costs for qualified transportation fringe benefits, parking facilities, and onsite gyms.

Changes to the 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.

An increase in the estate tax exemptions could significantly reduce the incentive for people (especially wealthy individuals) to make charitable contributions, as more property can now be transferred to beneficiaries tax-free.

Under the current law, private foundations must pay an excise tax on their net investment income; public charities, including colleges and universities, however, are excluded. Now, however, many nonprofits need to consider if this is setting up an unhealthy precedent for the future—one where politicians are increasingly telling the sector how they should spend their philanthropic assets.

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.

These provisions were enacted to equalize the treatment between taxable corporations that can no longer deduct these amounts and nonprofits.

The change limits bond issuers to current refundings in order to maintain the exclusion for the interest received by bondholders.

The bill 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.

On the Cutting Room Floor

One provision of particular interest to nonprofits failed to make it to the Conference Committee's version of the bill—the repeal of the Johnson Amendment. The House bill included a provision that would enable nonprofits to express their favor for a certain political candidate, even under the Johnson Amendment, which is designed to protect 501(c)(3) organizations from the demands from political candidates and donors for political endorsements and campaign contributions.

Reactions to the potential repeal were mixed, with some saying it could make nonprofits vulnerable to political demands by donors, while others thought it provided organization with freedom of speech, but at a level that would still prevent them from becoming political organizations. Although it was not included in the final version of the tax reform bill, the President has long been talking about his desire to lift these restrictions, so we may see this debate resurface in the coming years. Another provision that was not enacted and could have significantly impacted nonprofits was one that would have limited the royalty exclusion from UBIT.

Looking Forward

After a dramatic push to the finish line, tax reform is finally here. Nonprofits stand to be impacted significantly by various aspects of the bill, 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 deal with these changes. And, the impact of the bill extends beyond just the provisions for tax-exempt organizations. Many of the changes on the individual level, i.e. nearly doubling the standard deduction and eliminating the estate tax—could leave organizations facing significant cutbacks in donations next year. Comprehensive fiscal management that takes a holistic approach including the tax, audit, fundraising, and executive functions will be more vital than ever in 2018.

Here are three steps nonprofits should take now to tackle tax reform:

1. **Assemble a team** to assess the impact of the legislation on your organization.
2. **Dig into the data.** Assessing the impact of tax reform requires a substantial amount of data to be readily available. Nonprofits need to focus on data collection and computations as soon as possible.
3. **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 to navigate the state requirements as well.

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