House Passes Tax Bill; Senate Proposal on Track for Vote

On November 2, 2017, House Ways and Means Committee Chairman Kevin Brady (R-TX) introduced H.R. 1, the "Tax Cuts and Jobs Act" (the "Initial House Bill"). Our previous alert discussed the possible impact of certain provisions of the Initial House Bill on tax-exempt organizations. On November 16, 2017, the House of Representatives passed an amended version of H.R. 1 by a vote of 227-205 (the "Final House Bill"). The Final House Bill promises substantial changes to the Internal Revenue Code of 1986, as amended (the "Code").

On November 20, 2017, the Senate Finance Committee released the Senate's proposal for its own version of the Tax Cuts and Jobs Act (the "Senate Proposal"). A section-by-section summary is available here. On November 29, 2017, the Senate voted to begin debate on the legislation.

The Senate Proposal contains provisions that are consistent with the Final House Bill, but it also includes additional provisions that go beyond the Final House Bill, and leaves out certain provisions found in the Final House Bill.

The following is a discussion of both the Senate Proposal and certain provisions of the Final House Bill that were modified from the Initial House Bill, following our previous alert. All of the below provisions would be effective for taxable years beginning after December 31, 2017 unless otherwise noted.

(1) Increase in Standard Deduction (Senate Proposal Section 11021; Final House Bill Section 1002)

The Senate Proposal would increase the amount of the standard deductions for individuals for a seven year period (taxable years 2018 through 2025). During that time, the standard deduction would increase to $24,000 for married individuals filing jointly, $18,000 for head of household filers, and $12,000 for all other taxpayers. The Final House Bill would increase these amounts as well, to $24,400 for married individuals filing jointly, $18,300 for head of household filers, and $12,200 for all other taxpayers, and this provision would not sunset. Since only taxpayers who itemize their deductions can avail themselves of the deduction for charitable contributions, this provision could decrease popular interest in making charitable contributions.

(2) Excise Tax on Private Colleges and Universities (Senate Proposal Section 13701; Final House Bill Section 5103) and Private Foundations (Final House Bill Section 5101)

The Senate Proposal would impose an annual net investment income excise tax (similar to the excise tax currently applicable to private foundations) on applicable educational institutions (generally, private colleges and universities with more than 500 tuition-paying students per taxable year with at least $250,000 in assets per student, other than those assets which are used directly in carrying out the institution's exempt purpose). The excise tax would equal 1.4% of the net investment income of the institution for the taxable year. The Initial House Bill contained a similar provision, but used a lower asset floor for defining applicable educational institutions ($100,000 in assets per student); the Final House Bill now matches the Senate Proposal in this respect.

Additionally, both the Final House Bill and the Senate Proposal go further than the Initial House Bill, and add another provision that would treat the assets and net investment income of any related organization as the assets and net investment income of the applicable educational institution. A "related organization" means any organization (1) controlled by or in control of the educational institution, (2) controlled by one or more persons who control the educational institution, or (3) that is a supported or supporting organization with respect to the educational institution. However, the Senate Proposal notes that the assets and net investment income of a related organization will not be taken into account with respect to more than one educational institution, and unless the related organization is controlled by the educational institution or is a supporting organization with respect to such institution, assets and net investment income which are not intended or available for the use or benefit of the institution will not be taken into account.

The Final House Bill would also replace the current private foundation net investment income excise tax structure with a flat 1.4% excise tax on private foundations' annual net investment income (regardless of their charitable expenditures during the year), and the current rules providing for the reduction in the excise tax rate from 2% to 1% would be repealed. This provision is unchanged from the Initial House Bill. The Senate Proposal does not include a similar provision.

(3) Excise Tax on Excess Executive Compensation (Senate Proposal Section 13602; Final House Bill Section 3802)

The Final House Bill and the Senate Proposal both include a proposed excise tax on excess tax-exempt organization executive compensation. This proposal is unchanged from the Initial House Bill, as described in our prior alert, and involves the imposition of a 20% tax on the compensation (and certain severance payments) paid to an applicable tax-exempt organization's five highest compensated employees whose compensation exceeds $1,000,000 (or who receive an excess severance payment) in a given year, effectively penalizing the organization for making such payments. This provision would also apply to employees who met these thresholds in any taxable year beginning after December 31, 2016. An "applicable tax-exempt organization" would mean any organization exempt under Code Section 501(a) (e.g., 501(c) organizations such as private foundations, public charities, business leagues, social clubs, and social welfare organizations) and Code Section 115(1) (e.g., public universities), as well as exempt farmers' cooperatives and Code Section 527 political organizations. The tax would be payable by the tax-exempt organization and, if applicable, a related organization (on a proportional basis).

(4) Political Campaign Intervention by Section 501(c)(3) Organizations (Final House Bill Section 5201)

Effective for taxable years after December 31, 2018, the Final House Bill would broaden the applicability of the exception to the Johnson Amendment by permitting ***all*** Section 501(c)(3) organizations to participate or intervene in political campaigns in a limited manner through "statements" (we assume this term will be broadly construed) that are made in the ordinary course of an organization's regular and customary activities in carrying out its exempt purpose and that result in the organization incurring not more than *de minimis* incremental expenses. As proposed in the Initial House Bill, this exception applied only to churches. In addition, the Final House Bill includes a sunset condition not found in the Initial House Bill: Section 501(c)(3) organizations' ability to participate or intervene in political campaigns would not be permitted for taxable years beginning after December 31, 2023. The Senate Proposal does not include a similar provision.

(5) Name and Logo Royalties Treated as UBTI (Senate Proposal Section 13702)

The Senate Proposal would amend Code Sections 512 and 513 to subject royalty income derived from the licensing of any name or logo of an organization (including any trademark or copyright relating to such name or logo) to unrelated business income tax ("UBIT"). It would further repeal the exclusion of royalties or other income derived from any licensing of a name or logo of the organization from unrelated business taxable income ("UBTI"). Although the provision would not change the treatment of royalty income from licensing other types of intellectual property, the reach of the provision as drafted is not entirely clear. Neither the Initial House Bill nor the Final House Bill includes a similar provision.

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(6) UBTI Separately Computed for Each Trade or Business (Senate Proposal Section 13703)

Per the Senate Proposal, an organization with more than one unrelated trade or business would have to compute UBTI separately with respect to each trade or business without regard to the specific deduction allowed under Code Section 512(b)(12), and the organization's UBTI for that taxable year would be the sum of the amounts computed separately, less any specific deduction allowed under Code Section 512(b)(12). A net operating loss deduction would be allowed only with respect to the trade or business from which the loss arose (though this restriction would not apply to net operating losses carried over from taxable years beginning before January 1, 2018). Accordingly, it would generally not be possible to use a deduction for one unrelated trade or business to offset income from another unrelated trade or business for the same taxable year. Neither the Initial House Bill nor the Final House Bill includes a similar provision.

(7) Modification of Taxes on Excess Benefit Transactions (Intermediate Sanctions) (Senate Proposal Section 13705)

The below provisions are found only in the Senate Proposal.

a. Entity-level Tax in the Event of an Excess Benefit Transaction

If an initial tax is imposed on a disqualified person of an applicable organization under the intermediate sanctions rules, the proposal would subject the organization to an excise tax of ten percent (10%) of the excess benefit, unless the organization's participation in the transaction was not willful and was due to reasonable cause. However, no tax would be imposed if certain due diligence standards are met, or if the organization establishes to the satisfaction of the Secretary of the Treasury that other reasonable procedures were used to ensure that no excess benefit was provided. The proposed due diligence standards are the same as the procedures currently used to establish the rebuttable presumption of reasonableness with respect to excess benefit transactions.

b. Elimination of Rebuttable Presumption

The Senate Proposal would eliminate the rebuttable presumption of reasonableness contained in the intermediate sanctions regulations under Code Section 4958. Organizations that follow the procedures that presently result in such presumption would instead simply establish that an organization has performed the minimum standards of due diligence with respect to an arrangement involving a disqualified person, as described above, but would not shift the burden of proof to the IRS to prove unreasonableness.

c. Elimination of Certain Special Rules for Knowing Behavior by Organization Managers

The Senate Proposal would eliminate two special rules with respect to organization managers' participation in excess benefit transactions. The first rule that would be eliminated provides that an organization manager's participation in a transaction ordinarily is not considered "knowing," even if the transaction subsequently is held to be an excess benefit transaction, if the manager relied on professional advice. (Such reliance may still be a relevant consideration in determining whether the manager participated knowingly in the transaction, but would not, by itself, preclude the manager from being treated as participating in the transaction knowingly.) The second rule that would be eliminated provides that an organization manager ordinarily does not act "knowingly" for purposes of the excess benefit transaction excise tax if the organization has met the requirements of the rebuttable presumption procedure.

d. Treatment of Investment Advisors as Disqualified Persons

Current law treats investment advisors to donor advised funds as disqualified persons. The proposal would expand this treatment to investment advisors for all organizations that are subject to the intermediate sanctions rules. It would also modify the definition of "investment advisor" to mean any person compensated by an organization who is primarily responsible for managing the investment of, or providing investment advice with respect to, assets of the organization

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(or, for a sponsoring organization of a donor advised fund, any person other than an employee of the organization who is compensated by the organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the organization). The existing rules that treat as disqualified persons certain family members and 35% controlled entities of investment advisors to sponsoring organizations would also apply more broadly to investment advisors that are disqualified persons as to any organization subject to the intermediate sanctions rules. One result of this rule would be to essentially require organizations to review the compensation paid to such advisors and make a determination of reasonableness using comparability data.

e. Application of Intermediate Sanctions Rules of Code Sections 501(c)(5) and 501(c)(6) Organizations

The Senate Proposal would apply the intermediate sanctions rules to tax-exempt organizations described in Code Sections 501(c)(5) (labor and agricultural and horticultural organizations) and 501(c)(6) (business leagues, chambers of commerce and certain other organizations).

(8) Addition of Excess Business Holdings Tax Exception for Private Foundations (Senate Proposal Section 13706; Final House Bill Section 5104)

As discussed in our prior alert, the Initial House Bill included a provision excluding from the definition of excess business holdings a private foundation's ownership of certain "independently operated philanthropic businesses." A business enterprise would qualify as such if (1) the foundation owns 100% of the voting stock of the business at all times during the taxable year, and acquired such stock other than by purchase, (2) the business distributes all of its net operating income to the foundation within 120 days of the end of the taxable year, and (3) the business demonstrates that it is independently operated. Both the Final House Bill and the Senate Proposal include this new exception as well.

The Senate is poised to vote on the Senate Proposal in the near future, and we will provide further updates as the two chambers move toward reconciliation.

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