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Not-For-Profits & the Tax Cuts and Jobs Act of 2017

The new federal tax law that went into effect at the beginning of this year, the "Tax Cuts and Jobs Act of 2017" (Tax Act), will affect almost every type of individual and business in the country, and not-for-profit entities are no exception. Although the Tax Act provisions affecting the not-for-profit sector generally did not produce major headlines, these changes are poised to impact not-for-profits in a significant way.

Colleges and Universities

One category of not-for-profit that is certain to feel the influence of the Tax Act is institutions of higher education. The Tax Act imposes a 1.4 percent excise tax on the net investment income of select universities, effective for tax years beginning in 2018.[1] The affected universities are those with more than 500 students (provided that at least half of those students live in the United States), with university assets in excess of $500,000.[2] For these purposes, university assets do not include assets used directly in carrying out the university's exempt purposes,[3] but do include net investment income and assets of related organizations.[4]

Additionally, the Tax Act imposes an excise tax at the corporate rate (21 percent) on remuneration in excess of one million dollars for the five highest-paid employees at a § 501(c)(3) organization.[5] While all but the largest not-for-profits will skirt this issue—most not-for-profits on Long Island do not have even one employee who is compensated that highly—many colleges and universities will be unable to avoid it. Furthermore, because the period to qualify as a covered employee began in tax years beginning in 2017, affected not-for-profits were unable to plan ahead for this cost.[6]

Unrelated Business Income

Another category of not-for-profits affected by the Tax Act are those with unrelated business activities. When a tax-exempt organization conducts a trade or business not substantially related to its educational, charitable, or other purpose that is the basis of its tax exemption, it is liable for tax on income earned from that activity (this is called unrelated business income tax, or UBI tax).[7] For example, if a museum uses its theatre to show educational films to the public during operating hours, but rents the theatre out at night after hours for movie screenings, any income earned that the museum earned from those movie screenings would constitute UBI.

Previously, tax-exempt organizations that operated multiple unrelated business activities were permitted to aggregate the income, expenses, and associated deductions from those activities, thus affording them the opportunity to offset income from one unrelated activity with losses from another. Under the Tax Act, tax-exempt organizations must now calculate income or loss from each of their unrelated business activities separately.[8] This requirement is likely to increase both their

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tax liability and their associated administrative burden: these organizations will be unable to utilize any excess losses from one activity to reduce their tax liability owing on income from another, and will be required to track their income and expenses from separate activities in increased details. To add to the problem, the IRS has yet to issue guidance delineating what marks business activities as "separate."

The Tax Act also limits the use of net operating losses (NOLs) to 80 percent for tax years beginning after December 31, 2017, and disallows the carryback of NOLs.[9] However, it permits an indefinite carryforward of NOLs.[10] For not-for-profits, these changes will be concentrated in their UBI tax calculations. Note that the Tax Act does not impose the 80 percent limitation on NOLs originating prior to 2018.

Continuing on the subject of increased UBI tax, the Tax Act classifies certain employer-provided fringe benefits, previously not taxed, as UBI. These include transportation benefits, such as commuting and parking expenses, and on-premises gym facilities.[11] While these benefits will continue to be tax-free for employees, not-for-profits will now owe UBI taxes for them. UBI is taxed at the new flat corporate rate of 21 percent.[12] Prior to the Tax Act's passage, the corporate rate was 15 percent on the first $50,000 of taxable income, and gradually increased to 35%. Notably, while the shift to the 21 percent flat rate is generally perceived as a reduction in the corporate tax rate, many not-for-profits that generate only a small amount of UBI may actually see an increase in their tax liability as a result of this change.

Charitable Giving

Finally, much has been made of the increased standard deduction, and its potential effect on charitable giving. Prior to the passage of the Tax Act, according to the latest data available from the IRS, approximately 30 percent of individual filers itemized their deductions. Under the Tax Act, the standard deduction has been doubled, and the percentage of filers projected to itemize their deductions is estimated, consequently, to decrease to between five and ten percent. Thus, the vast majority of taxpayers are not projected to be taking the itemized deduction for charitable contributions.

With reduced tax incentives, the thinking goes, people will make fewer charitable gifts. However, this logic may very well misunderstand what motivates the average taxpayer to support his or her favorite charitable causes. Whether or not tax incentives affect charitable contributions has been the subject of some debate in the past. One commonly-accepted line of thinking is that the amount that Americans give to charity each year is fixed at roughly 2 percent of the nation's GDP, tax incentives (or the lack thereof) notwithstanding.[13] Other studies, however, suggest that households' contributions to the charitable sector, particularly upper-income households, are highly sensitive to tax incentives.[14] It remains to be seen whether or not the revamped tax landscape will be the blow that many in the not-for-profit sector are anticipating.

Relatedly, the Tax Act increased the federal estate tax exclusion from $5.49 to $11.2 million per person,[15] thus reducing the tax incentive to make major charitable bequests at death for those individuals with estates valued in that range. Again, if charitable gifts are truly driven taxpayers' bottom lines and not their hearts, the Tax Act may negatively impact the potential recipients of major gifts (such as hospitals, colleges, and universities). Note, however, that there has been no similar increase to the New York State exclusion; for the 2018 calendar year, it is $5.25 million. As a result, New York charities can take comfort in the fact that New Yorkers who will benefit from the increased federal exclusion will still owe significant tax on the state side, and may give accordingly.

The foregoing focuses on just a few provisions of the Tax Act that relate to not-for-profits; there are many others that must be noted and digested. Additionally, although Congress passed the Tax Act almost a full year ago, the breadth and depth of its effect on the not-for-profit sector is yet to be revealed. Not-for-profits should pay close attention to any forthcoming guidance from the IRS, especially with respect to UBI issues, and should consider revising any marketing approaches that focus on the tax incentives of charitable giving to correspond to current law.

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1. IRC § 4968.
2. IRC § 4968(b).
3. *Id.*
4. IRC § 4968(d).
5. IRC § 4960.
6. IRC § 4960(c)(2)(B).
7. IRC § 512.
8. IRC § 512(a)(6).
9. IRC § 172(a).
10. IRC § 172(b).
11. IRC § 512(a)(7).
12. IRC § 511.
13. *See, e.g.*, "The Stubborn 2% Giving Rate" by Suzanne Perry. *The Chronicle of Philanthropy* (Jun. 17, 2013).
14. Duquette, Nicolas J. (2014). "Do Tax Incentives Affect Charitable Contributions? Evidence from Public Charities' Reported Revenues."
15. H.R. 1 § 11061.