Nonprofit Alert: The Effects of Recent Tax Reform on Nonprofits

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The recent federal tax changes impact tax-exempt organizations in several ways. The increased standard deduction and estate tax exclusions reduce the federal tax incentives to give to charity for some taxpayers, however, the legislation also created a modest incentive aimed at increasing cash gifts to charities. In addition, the legislation affects how tax-exempt organizations calculate their unrelated business income tax liability and imposes a tax on certain executive compensation and severance payments.

Increase of the Standard Deduction and Cap on State and Local Tax Deduction

Pursuant to prior law, the standard deduction for the 2017 tax year is $6,350 for single taxpayers and $12,700 for married couples filing jointly. For the 2018 through 2025 tax years, the Act increases the standard deduction to $12,000 for individuals and $24,000 for married couples filing jointly. These amounts are indexed for inflation based on the chained consumer price index. The Act also caps the deduction for state and local taxes at $10,000.

These changes will cause significantly fewer taxpayers to itemize their deductions. Because a taxpayer may only claim the charitable deduction if the taxpayer itemizes his or her deductions, the increase in the standard deduction will eliminate the federal tax incentive to give to charity for many taxpayers. However, current Minnesota law allows taxpayers who do not itemize their federal tax deductions to subtract an amount equal to 50 percent of their charitable contributions over $500 from the calculation of their income for state income tax purposes.

Increase in AGI Percentage Limit for Charitable Contributions of *Cash* to Public Charities

The Internal Revenue Code (the "Code") limits the amount a taxpayer may claim as a charitable deduction to a certain proportion of his or her "contribution base," which is generally the taxpayer's adjusted gross income. The applicable percentage limit varies based on the type of gift and the recipient. Under prior law, a taxpayer could claim a charitable deduction of up to 50 percent of his or her contribution base if the taxpayer made a gift of cash or other non-appreciated property to a public charity (as opposed to a private foundation). The Act increases the limit applicable to gifts of <u>*cash*</u> to public charities to *60 percent* of the taxpayer's contribution base.

Doubling the Estate, Gift, and GST Tax Exclusions for 2018-2025 Tax Years

For more information about these changes, see this GPM Estate Planning Alert. Due to these changes, fewer taxpayers will have a federal tax incentive to give to charity in order to reduce their estate, gift, or generation skipping transfer tax liability.

UBTI to Be Computed Separately for "Each Line of Business"

Within certain limits, tax-exempt organizations may derive income from a trade or business that is not substantially related to the organization's tax-exempt purposes. However, that income is generally subject to the tax on unrelated business taxable income (UBTI), unless an exception applies.

Under prior law, a tax-exempt organization determined its amount of UBTI by aggregating its income from all of its activities which produced unrelated business income and subtracting the aggregate amount of deductions directly connected with all of the unrelated businesses. The Act requires tax-exempt organizations to compute their unrelated business income separately for each trade or business. Accordingly, an organization will not be able to use a deduction from one trade or business to offset income from a different trade or business.

Exempt Organizations Will Have to Pay Tax on Certain "Fringe Benefits" Provided to Employees

The Act modifies prior law so that for-profit businesses now generally cannot deduct from their income taxes the expense of providing "qualified transportation fringes" to employees or for providing transportation for commuting between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee or in the case of certain qualified bicycle commuting reimbursement. With the apparent intent of applying this new rule to tax-exempt organizations, the Act provides that UBTI will include expenses paid or incurred by a tax exempt organization for providing its employees with qualified transportation fringe benefits to the extent such expenses are not deductible by a for-profit business. Tax-exempt organizations need not include amounts paid for qualified transportation fringe in UBTI if the amounts are directly connected with an unrelated trade or business which is regularly carried on by the organization.

Excise Tax on Certain Exempt Organizations' Executive Compensation and Parachute Payments

Publicly held, for-profit corporations generally cannot deduct from their income taxes certain compensation over $1 million paid to "covered employees" in a taxable year. These for-profits also cannot deduct certain "excess parachute payments" paid to highly compensated individuals upon a change of corporate control or ownership.

The Act generally applies these provisions to tax-exempt organizations, with some modifications so that a tax-exempt organization is liable for a 21 percent tax on any remuneration paid to a covered employee over $1 million. In addition, tax-exempt organizations are liable for "excess parachute payments" paid to "highly compensated employees" even if the employee's remuneration does not exceed $1 million. A "covered employee" of a tax-exempt organization includes an employee or former employee who is one of the five highest compensated employees of the organization. Remuneration paid to covered employees from "related organizations" is included in calculating the total remuneration paid to the employee. The new rule also contains an exception for remuneration paid to a medical doctor, nurse, or veterinarian which is directly related to the performance of medical or veterinary services.

Excise Tax on Certain Private College and University Endowments

The Act imposes a new 1.4% tax on the net investment income of "applicable educational institutions." Among other requirements, to constitute an "applicable educational institution," an institution must have at least 500 students, 50 percent of whom are located in the United States, and have assets of at least $500,000 per student. The Bipartisan Budget Act of 2018 limits the application of this tax to institutions with at least 500 "*tuition paying*" students. Assets which are used directly in carrying out the institution's exempt purpose are not included. This new tax does not apply to state colleges and universities.

Join Gray Plant Mooty on April 24 for a breakfast briefing, "Navigating the New Tax Law Changes in the Nonprofit World," discussing these issues and other changes affecting nonprofits. Contact GPM's Nonprofit Organizations team with questions. Click here form more information and to register.