

STROOCK SPECIAL BULLETIN

Five Provisions of the Tax Reform Act That Will Affect Tax-Exempt Organizations

January 30, 2018

Although most of the attention from the Tax Reform Act signed by President Trump on December 22, 2018 (Public Law 115-97, informally known as the “Tax Cuts and Jobs Act”), has focused on provisions in the Act that affect individuals and businesses, there are a number of provisions that are specifically applicable to exempt organizations. This **Stroock Special Bulletin** discusses five significant provisions in the Tax Reform Act that affect tax-exempt organizations starting in 2018.

Limitations on Using Losses to Offset Unrelated Business Taxable Income

When an exempt organization recognizes income from a trade or business that is not substantially related to its exempt purposes or income that is attributable to debt-financed property, the income (“unrelated business taxable income” or “UBTI”) generally is subject to unrelated business income tax at the highest applicable marginal tax rates. Previously, tax-exempt organizations could net their losses from one unrelated trade or business against income from another unrelated trade or business and pay tax on only the net income. The Tax Reform Act requires a tax-exempt organization to calculate UBTI separately for each trade or business in which it has an interest and

does not allow such netting. Accordingly, if an exempt organization is engaged in three different activities and has income from two of the activities and losses from the third, the organization will be required to include the income from the two profitable activities as UBTI without reduction for the losses incurred in the third activity.

By the same token, net operating losses (“NOLs”) incurred starting in 2018 can only be used to offset taxable income from the same trade or business in which the NOLs were incurred. However, NOLs generated before January 1, 2018 will be grandfathered and may reduce UBTI from any unrelated trade or business in subsequent years.

It is not clear how this provision will define a trade or business activity. For example, will an exempt organization that owns an interest in two different partnerships, each of which is engaged in farming, be treated as one trade or business activity or two? If an exempt organization sells books in one store that it owns and computers in a separate store, will the different sales be treated as a single business activity? Other areas of the Internal Revenue Code of 1986, as amended (the “Code”) and Treasury Regulations require the segregation of trade or business activities, including rules regarding losses incurred in activities that are not engaged in for profit under Section 183 of the Code, the at-risk

rules under Section 465 of the Code, and the passive activity loss rules under Section 469 of the Code. Whether similar rules will be applied to this provision remains to be seen.

The inability to offset losses from one unrelated trade or business against gains from another (or against gains and losses from pass-through entities) may increase certain exempt organizations' overall UBTI but the benefit of the reduction of the corporate tax rate from 35% to 21% will benefit many tax-exempt organizations that already have UBTI. In order to mitigate the adverse consequences from this provision, exempt organizations with multiple unrelated trade or business activities may consider moving activities to one taxable corporate subsidiary to allow income to be offset by losses from unrelated business activities. However, the reduction in the corporate tax rate to 21% under the Tax Reform Act may mitigate any adverse consequences of this new loss limitation for exempt organizations.

New Excise Tax On Investment Income of Private Colleges and Universities

The Tax Reform Act imposes a 1.4% excise tax on the “net investment income” of a private educational institution if the institution has at least 500 students, more than 50% of which are located in the United States, and the aggregate fair market value of the institution's assets (other than assets used directly in carrying out its educational purpose) is at least \$500,000 per student. For purposes of determining whether an institution meets the asset-per-student threshold and determining net investment income, assets and net investment income would include amounts with respect to an organization that is related to the institution. It is understood that approximately 30 educational institutions will be subject to this tax – mainly large private universities and some better-funded smaller colleges. State universities will not be subject to this tax.

This provision would effectively treat certain private colleges and universities as private

foundations which are subject to a 2% excise tax under Section 4940 of the Code on their net investment income (generally, interest, dividends, rents and royalties) and capital gain net income, reduced by related expenses. It is expected that the application of this provision will be similar to the excise tax on net investment income imposed on private foundations. The Secretary of the Treasury has the authority to promulgate regulations to carry out the intent of this provision, including regulations that describe: (1) assets that are used directly in carrying out the educational institution's exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of the educational institution.

New Taxes on Executive Compensation

In what appears to be an attempt to align compensation paid to executives of tax-exempt organizations with the compensation limits imposed on public company executives, the Tax Reform Act imposes a new tax at the corporate tax rate (21 percent in the Tax Reform Act) on any remuneration paid to “covered employees” by the tax-exempt organization (or any related organization) in excess of \$1 million effective for tax years beginning after December 31, 2017. A “covered employee” is one of the five highest compensated employees of the organization for the taxable year and any individuals who were covered employees for any preceding tax year starting with tax years beginning after December 31, 2016. There is an exception for the healthcare sector, exempting from the excise tax compensation paid to employees that are licensed medical professionals providing medical services.

This tax also applies to an exempt organization that makes any “excess parachute payments” to a covered individual if the aggregate present value of all such payments to an individual equals or exceeds three times the individual's base amount. The definition of excess parachute payment borrows from the Code Section 280G regime

(referring to Code Section 280G for rules for applying base amounts, calculation of present value, etc.); however, rather than focusing on payments contingent on a change in control, parachute payment is defined in reference to payments contingent on the employee's separation from employment from the employer.

Charitable Contributions

One potentially significant change made by the Tax Reform Act that could adversely affect charities is the doubling of the standard deduction, which for a married couple filing jointly is raised to \$24,000. This change, coupled with the limitation on state and local tax deductions to \$10,000, will mean that many taxpayers will find the standard deduction more beneficial than itemizing deductions. As a result, taxpayers may be less incentivized to make charitable contributions for which they will not receive a tax benefit.

For individuals who itemize tax deductions, charitable contributions can be deducted but are subject to limits based on the individual's "adjusted gross income" ("AGI"). The Tax Reform Act increases the limit for cash contributions in any year to most charitable organizations from 50 percent to 60 percent of the individual's AGI for that year, with certain carry-forwards.

Certain Fringe Benefits Included in the Calculation of UBTI

The Tax Reform Act treats amounts paid by tax-exempt organizations for certain fringe benefits offered to employees as UBTI (provided that the amounts are not deductible under Section 274).

The fringe benefits to which this provision applies include qualified transportation fringe benefits, any parking facility used in connection with qualified parking, and on-premises athletic facilities. This provision does not apply to payment of amounts that are directly connected with a regularly carried-on unrelated trade or business. This provision attempts to create parity with another newly-enacted provision applicable

to taxable organizations that eliminates a tax exemption for these employer-provided fringe benefits.

Proposed Changes Not Included in the Tax Reform Act

The final version of The Tax Reform Act does not include a number of tax-exempt organization provisions included in earlier House and Senate versions of the bill. Significantly, proposals to subject state and local entities (including state pensions plans) to the rules governing UBTI, which would have subjected such entities to a tax on income derived from a trade or business that is not substantially related to such entity's tax exempt purpose, were eliminated from the final version of the bill.

The House bill proposed significant restrictions on the exclusion from income for interest paid on private activity bonds, including bonds issued to finance charitable activities of exempt organizations. In the final version of the Tax Reform Act, interest paid on private activity bonds remains tax exempt. However, the Tax Reform Act did impose significant limitations on the use of advanced refunding bonds.

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