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2017 Tax Legislation's Effect on a Tax-Exempt Organization

Introduction

As you know, Congress enacted sweeping legislation at the end of December. The voting was contentious and lawmakers were changing the legislation's contents up to the last minute. Because of this chain of events, there are numerous provisions that either Congress needs to correct because they are technically incorrect as written and/or the IRS needs to issue a further explanation so we can interpret them with a fair amount of certainty. We say this because our comments below are limited to the plain language of the law. We will continue to monitor any changes and interpretations and provide you an update as they occur. Unless otherwise stated, the law changes are effective for taxable years beginning after December 31, 2017.

Unrelated Business Taxable Income - More Than One Business Activity

As you know, a tax-exempt organization generally may have revenue from four sources: contributions, gifts and grants; business income that is related to exempt activities (e.g., program service revenue); investment income; and business income that is not related to exempt activities. The federal income tax exemption generally applies to the first three categories, but does not apply to an organization's

unrelated business income.

The unrelated business income tax generally applies to an organization's business income that it regularly carries on, but is not substantially related to its tax-exempt mission. An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated business. Prior to the legislation, an organization that operated multiple unrelated businesses aggregated the income from all such activities and subtracted from it the aggregated deductions. Thus, an organization could have been using deductions from one unrelated business to offset income from another, thereby reducing total unrelated business taxable income subject to tax.

The legislation changed the netting rules for multiple activities. An organization with more than one unrelated business must compute unrelated business taxable income for each business. The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each business. A net operating loss deduction may be used to offset only the income from the separate business that generated the loss.

We will discuss later changes to business deductions that may limit an organization's unrelated business deductions.

Unrelated Business Taxable Income- Increase Disallowed Employee Fringe Benefits

The tax law prior to, and after, the enactment of the 2017 legislation enables an employer to provide its employees tax-free certain types of fringe benefits. For purposes of this discussion, we are referring to qualified transportation, qualified parking and on-premise athletic facility fringe benefits. The end-result of the tax legislation is that an employer may lose its regular income tax deduction for providing such fringe benefits, and will have to include the expenditures in its unrelated business taxable income.

A qualified transportation fringe benefit includes a transit pass, parking, bicycle commuting

reimbursement and transportation in a commuter highway vehicle. We are expecting the IRS to issue guidance for this law change. For example, employee-parking means parking provided to an employee on or near the employer's business premises. Without further explanation, this mean an employer needs to impute a fair market value of such parking.

This increase to unrelated business taxable income does not apply if the fringe benefit relates to the employer's unrelated business. Furthermore, this rule does not apply to the extent the employer is including the value of the fringe benefit in the employee's taxable wages.

This law change applies to amounts paid or incurred after December 31, 2017. Unless we receive guidance in the upcoming months, we strongly encourage an organization to consider filing an extension for a federal and state Form 990-T, Exempt Organization Business Income Tax Return.

Other Tax Legislation That May Affect Your Unrelated Business Taxable Income

Other tax legislation that may affect your unrelated business tax calculation include:

- **Corporate tax rates reduced.** The corporate tax rate is reduced to a flat 21% from a graduated maximum 35% rate. Therefore, the tax on unrelated business taxable income is a flat 21%. In prior years, the first $50,000 of taxable income was subject to a 15% tax rate.

- **Alternative minimum tax repealed for corporations.** Congress repealed the corporate alternative minimum tax.

- **Net operating loss deduction modified.** A net operating loss arising in tax years ending after 2017 can only be carried forward, not back. Such a net operating loss can be carried forward indefinitely, rather than expiring after 20 years. Additionally, for losses arising in tax years beginning after 2017, the net operating loss carried forward deduction is limited to 80% of taxable income.

- **Entertainment expenses and club dues.** The new law eliminates the 50% deduction for business-related entertainment expenses. The pre-Act 50% limit on deductible business meals is

expanded to cover meals provided by an in-house cafeteria or otherwise on the employer's premises.

Other relevant tax law changes that may affect your organization:

- **Employee achievement awards clarified.** An employee achievement award is tax-free to him/her to the extent the employer can deduct its cost, generally limited to $400 for one employee or $1,600 for a qualified plan award. An employee achievement award is an item of tangible personal property given to an employee in recognition of length of service or a safety achievement and presented as part of a meaningful presentation. The new law defines "tangible personal property" to exclude cash, cash equivalents, gift cards, gift coupons, gift certificates (other than from an employer pre-selected limited list), vacations, meals, lodging, theater or sports tickets, stocks, bonds, or similar items, and other non-tangible personal property.

- **Qualified moving expense reimbursements.** Previously, an employer's reimbursement of an employee's qualified moving expenses was not taxable to the employee. The new law repeals the exclusion from the employee's taxable wages.

- **Suspension of exclusion for qualified bicycle commuting reimbursement.** Previously, an employer's reimbursement to its employee for up to $20 per qualifying bicycle commuting month was not considered taxable wages. A qualifying bicycle commuting month is any month during which the employee regularly uses his/her bicycle for a substantial portion of travel to work. The new law treats such reimbursements as taxable wages.

- **Modification of rules applicable to length of service award plans.** Special rules apply to deferred compensation plans sponsored by a state and local government and a non-for profit employer. An exception to these rules applies to a plan solely paying length of service awards to bona fide firefighting and fire prevention services, emergency medical services and ambulance services volunteers. An individual is treated as a bona fide volunteer for this purpose if the only compensation he/she receives for performing qualified services is in the form of (1) reimbursement for reasonable expenses, or (2) reasonable benefits (including length of service awards) and nominal fees for the services. Previously, the exception applied only if the annual aggregate amount accruing to a volunteer

did not exceed $3,000.

The new law increases to $6,000 from $3,000 the aggregate amount, and adjusts that amount in $500 increments to reflect changes in subsequent years' cost-of-living. Also, if the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of awards accruing with respect to any year of service.

Individual's Charitable Deduction. The tax law made the following changes to an individual's claiming a charitable income tax deduction:

- The adjusted gross income limitation for cash gifts made to public charities increases to 60% from 50%.

- A taxpayer no longer may claim a charitable deduction for an amount contributed to a college or university in exchange for the right to purchase stadium seating.

- A charitable organization must issue a contemporaneous written acknowledgement for a $250 or more donation. The new law repeals the previous exception for certain contributions reported by the donee organization.

Excise Tax on Excessive Executive Compensation

The new law imposes on an employer a 21% excise tax based on "excessive" compensation paid to a defined employee group. Excessive compensation is the sum of remuneration paid in excess of $1 million and excess parachute payments. The employee group includes the five highest compensated employees during a taxable year, and/or an employee who was included in such a group in a preceding taxable year beginning after December 31, 2016.

The above definitions are complex and contain exceptions and related party rules. Remuneration, in general, includes taxable wages plus deferred compensation from an "ineligible" deferred compensation plan (which is a plan that does not meet the IRS requirements to be an eligible plan under Section

457(b)). A large exception to the remuneration definition is for compensation paid to a licensed medical professional.

Excess parachute payments relate to compensation paid to an employee included in the group defined above that is contingent on his/her separation from employment. The “excess” portion is the aggregate present value of the payments that equals or exceeds an amount equal to three times the “base amount.” The base amount is an employee’s average annual compensation for the most recent five taxable years.

Please call us if you believe you may have an employee for which this provision applies. We will need to discuss in more detail your situation.

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