Simpson Thacher

Memorandum

Provisions of Interest to Tax-Exempt Organizations and Donors in the Tax Reform Legislation

December 22, 2017

President Trump today signed into law comprehensive tax reform legislation (the "Law"). This memorandum summarizes the changes under the Law to the Internal Revenue Code of 1986, as amended (the "Code"), that will affect tax-exempt organizations and donors to tax-exempt organizations.[1]

Tax-Exempt Employers Will be Subject to a New Excise Tax on Certain Executive Compensation

The Law will result in significantly increased costs for tax-exempt organizations with highly-compensated executives. New Code section 4960 imposes on tax-exempt organization employers an excise tax payable at the new corporate rate of 21% on the amount of (i) remuneration (other than any excess parachute payments) in excess of $1 million paid with respect to any covered employee and (ii) any excess parachute payment made to any covered employee.

A "covered employee" is any employee or former employee that (i) is one of the five highest-compensated employees of the tax-exempt organization in the taxable year, or (ii) was a covered employee of the tax-exempt organization or any predecessor for any preceding taxable year beginning after December 31, 2016. As a result, a tax-exempt organization may have greater than five covered employees in any particular taxable year.

"Remuneration" means wages (as defined in Code section 3401(a)), but excludes any designated Roth contribution (as defined in Code section 402A(c)), and, in the case of remuneration paid to a licensed medical professional (including a veterinarian), excludes the amount that is paid for the performance of

[1] For a more general summary of the Law's provisions, please see the memorandum of Simpson Thacher & Bartlett LLP's Tax Department, available here.

medical or veterinary services. Remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to the remuneration. Remuneration by a tax-exempt organization will include remuneration paid with respect to employment of the covered employee by a related organization. For this purpose, a "related organization" is a person or governmental entity that controls, is controlled by or is under common control with the tax-exempt organization, that is a supported organization described in Code section 509(f)(3) or a supporting organization described in Code section 509(a)(3) with respect to the tax-exempt organization, or, in the case of a voluntary employees' beneficiary association described in Code section 501(c)(9) (a "VEBA"), that establishes, maintains or makes contributions to the VEBA. Where remuneration from more than one employer is taken into account in determining the excise tax, each employer will be liable for its proportionate share of the tax.

An "excess parachute payment" is a payment triggered by an employee's separation from the employer in an amount that equals or exceeds three times his or her five-year average total compensation, subject to certain exceptions.

New Code Section 4960 provides that Treasury Regulations will be promulgated as necessary to prevent the avoidance of the new excise tax, including through the performance of services as a contractor rather than as an employee or by providing compensation through a pass-through or other entity. We expect that tax-exempt organizations will also need further guidance regarding the definition of control in determining whether an entity is a related organization for purposes of the new excise tax. In addition, tax-exempt organizations in complex networks of organizations, particularly those including both tax-exempt and taxable entities, will need further guidance in determining how to allocate the new excise tax among different employing entities.

Importantly, the new excise tax imposed on tax-exempt organization employers under Code section 4960 is in addition to the existing excise tax regime under Code section 4958. Code section 4958 imposes excise taxes on excess benefit transactions. Unlike the new excise tax under Code section 4960, the excise taxes under Code section 4958 are paid by the disqualified person (*e.g.*, officers and certain senior executives of a tax-exempt organization) engaged in the excess benefit transaction, and, in certain cases, by the management of the tax-exempt organization. An "excess benefit transaction" is any transaction where the value of the economic benefit provided by the tax-exempt organization exceeds the value of the consideration provided by the disqualified person, and may include a compensation arrangement. The Treasury Regulations under Code section 4958 provide procedures that a tax-exempt organization may follow to create a rebuttable presumption that a compensation arrangement is reasonable. Notably, the new excise tax under Code section 4960 is payable regardless of the reasonableness of the compensation under Code section 4958.

Tax-exempt organizations with highly-compensated employees should carefully review existing compensation arrangements in consideration of the new excise tax under Code section 4960. The new excise tax should also be considered when entering into new employment or compensation arrangements.

This provision will be effective for taxable years beginning after December 31, 2017.

Certain Private College and University Endowments Will be Subject to a New Excise Tax on Net Investment Income

In a significant change, private colleges and universities will be subject to an excise tax on net investment income that is similar to the excise tax imposed on private foundations. Private colleges and universities are those that are not agencies or instrumentalities of, or owned by, a governmental entity (*i.e.*, those that are not state or community colleges or universities).

New Code section 4968 imposes an excise tax equal to 1.4% of the net investment income of any private college or university with 500 or more students, at least half of whom are located in the United States, if the private college or university has investment assets with a fair market value of at least $500,000 per student.

The net investment income, as well as the investment assets, of any organization that controls, is controlled by or is under common control with the private college or university, or that is a supported organization described in Code section 509(f)(3) or a supporting organization described in Code section 509(a)(3) with respect to the private college or university (collectively, "related organizations"), will generally be attributed to the private college or university for purposes of determining the amount of the excise tax. Attribution will not apply to net investment income or investment assets of a related organization if they are not intended or available for the use or benefit of the private college or university, unless the related organization is controlled by, or a supporting organization of, the private college or university. These attribution rules limit the ability of a private college or university to restructure its endowment to avoid the excise tax.

Several important matters remain to be clarified in Treasury Regulations expected to be promulgated in the future. First, new Code section 4968 specifies that the definition of the net investment income of a private college or university will be determined under rules similar to those of Code section 4940(c), which defines net investment income for private foundations. The Treasury Regulations are expected to describe the definition and determination of net investment income. These rules are critical to the application of new Code section 4968. Importantly, the rules established under Code section 4940(c) for private foundations in 1969 were not retroactive for purposes of determining the capital gains component of net investment income, and established December 31, 1969 as the floor for the tax basis of property held on that date. It would be appropriate for the new Treasury Regulations to follow this precedent and establish December 31, 2017 as the floor for the tax basis of property held by private colleges and universities as of the effectiveness of Code section 4968. Second, Treasury Regulations are expected to describe the assets of a private college or university that are investment assets, as opposed to those that are used directly in carrying out its

educational purposes. Finally, for purposes of attribution, the Treasury Regulations are expected to describe the assets of a related organization that are intended or available for the use or benefit of the private college or university. In this regard, we expect that private colleges and universities will need further guidance regarding the definition of control in determining whether an entity is a related organization.

This provision will be effective for taxable years beginning after December 31, 2017.

Unrelated Business Taxable Income Will be Determined Using Modified Computation Rules

Although generally not subject to tax, tax-exempt organizations are subject to unrelated business income tax ("UBIT") under Code section 511 on their unrelated business taxable income ("UBTI") as defined in Code section 512. The Law significantly changes the UBTI computation rules, particularly for tax-exempt organizations with more than one unrelated trade or business.

Offsetting Gains and Losses

Under new Code section 512(a)(6), a tax-exempt organization must compute UBTI separately for each unrelated trade or business. This is a material change from current law, where a tax-exempt organization may aggregate income and deductions (including deductions for net operating losses) from its various unrelated trades and businesses, thereby allowing the tax-exempt organization to use a deduction from one unrelated trade or business to offset income from another and hence reduce its UBTI. Because a tax-exempt organization must now compute UBTI separately for each unrelated trade or business under new Code section 512(a)(6), a tax-exempt organization may no longer apply a deduction from one trade or business to offset income from another, although it may use deductions from a specific unrelated trade or business activity accrued in one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate. Under a transition rule, if a tax-exempt organization has existing net operating losses from its unrelated trade or business activity in taxable years prior to January 1, 2018, those losses may be carried forward and used to offset its UBTI after it has otherwise calculated its UBTI in accordance with new Code section 512(a)(6).

Under current law, tax-exempt organizations have not generally been required to distinguish between different unrelated trades and businesses, including in reporting UBTI. As result, we expect that tax-exempt organizations will need further guidance in distinguishing unrelated trades and businesses. In addition, new Code section 512(a)(6) will require material changes to the annual tax returns used by tax-exempt organizations to report UBIT to the Internal Revenue Service.

Fringe Benefits

In addition to the computation changes described above, new Code section 512(a)(7) provides that a tax-exempt organization's UBTI will be increased by certain amounts paid or incurred for certain fringe benefits.

Specifically, a tax-exempt organization's UBTI will be increased by any amount paid or incurred and for which a deduction under Code section 274 is not allowable, for any qualified transportation fringe (as defined in Code section 132(f)), any parking facility used in connection with qualified parking (as defined in Code section 132(f)(5)(C)), and any on-premises athletic facility (as defined in Code section 132(j)(4)(B)), in each case, that is not directly connected to an unrelated trade or business that is regularly carried on by the tax-exempt organization. Treasury Regulations are expected to be promulgated for purposes of carrying out the new UBTI inclusions.

These provisions will be effective for taxable years beginning after December 31, 2017.

Certain Charitable Contribution Deduction Rules Will Change

The Law includes three changes relating to the charitable contribution deduction for individual and corporate taxpayers under Code section 170.

Increased AGI Limitation for Certain Charitable Contributions

Charitable contributions by individual taxpayers to tax-exempt organizations are generally limited to a specified percentage of the individual's adjusted gross income ("AGI") for a taxable year. In general, more favorable (*i.e.*, higher) AGI percentage limitations apply to contributions of cash and appreciated property to tax-exempt organizations classified as public charities, private operating foundations, as well as to flow-through foundations and certain governmental units. Specifically, under current law, an individual taxpayer may claim a charitable contribution deduction for cash contributions to public charities, private operating foundations, flow-through foundations and certain governmental units in any given year of up to 50% of his or her AGI. Under the Law, an individual taxpayer may now claim a charitable contribution deduction for cash contributions to public charities, private operating foundations, flow-through foundations and certain governmental units in any given year of up to 60% (rather than 50%) of his or her AGI.

Elimination of Charitable Contribution Deduction for Contributions Related to Athletic Seating

In addition, the Law eliminates any charitable contribution deduction under Code section 170 for a charitable contribution to a college or university if the taxpayer receives the right to purchase tickets or seating at an athletic event at the college or university in exchange for the contribution. Under current law, a charitable contribution deduction (limited to 80% of the contribution amount) is allowed for such contributions.

Elimination of the Contemporaneous Written Acknowledgment Exception

Finally, no charitable contribution deduction will be allowed under Code section 170 for a charitable contribution of $250 or more to a tax-exempt organization unless the taxpayer (whether an individual or corporation) obtains a contemporaneous written acknowledgment of the contribution from the recipient tax-

exempt organization. Under current law, Code section 170 provides an exception to the contemporaneous written acknowledgment requirement if the recipient organization files a return (*e.g.*, IRS Form 990 or Form 990-PF) that includes the same information required in a contemporaneous written acknowledgment, with the exception not effective until the issuance of final Treasury Regulations. Treasury Regulations were issued in proposed but not final form in October 2015, and then withdrawn in January 2016. The Law has eliminated this exception to the contemporaneous written acknowledgment requirement from Code section 170, meaning that taxpayers now will need to continue to proactively obtain contemporaneous written acknowledgments of charitable contributions of $250 or more from recipient tax-exempt organizations.

These amendments to Code section 170 will generally be effective for charitable contributions made in taxable years beginning after December 31, 2017. However, the increased AGI limitation for cash contributions by individual taxpayers to public charities, private operating foundations, flow-through foundations and certain governmental units will sunset on December 31, 2025. In addition, the elimination of the contemporaneous written acknowledgment exception will be effective for charitable contributions made in taxable years beginning after December 31, 2016.

The Exclusion for the Estate, Gift and Generation-Skipping Tax Will Increase

The Law doubles the exclusion from the estate, gift and generation-skipping tax (from $5 million to $10 million, indexed for inflation) for decedents dying or gifts made after December 31, 2017 and before January 1, 2026.

Other Proposals Not Included in the Law

Earlier tax reform proposals included a number of provisions that would have impacted tax-exempt organizations and/or donors to tax-exempt organizations that are not included in the Law.

- In the political campaign activities area, a proposal would have eliminated the so-called Johnson Amendment, which imposes an absolute prohibition on political campaign activities by charitable organizations under Code section 501(c)(3). The proposal would have allowed for certain political campaign activities in the ordinary course of the charitable organization's activities that resulted in no more than *de minimis* incremental expenses. This change is not included in the Law.
- In the exemption area, a proposal would have amended Code section 501(c)(6) to make professional sports leagues ineligible for tax-exempt status under that section. This change is not included in the Law.
- In the private foundation area, there were several other proposals. One proposal would have eliminated the two-tier excise tax on private foundation investment income under Code section 4940 in favor of a single tax. Although the Law imposes a single 1.4% excise tax on private college and university endowment net investment income, as discussed above, Code section 4940 retains the 2%

excise tax, which is subject to reduction to 1%, for private foundations. Another proposal would have required so-called private museums to maintain a minimum number of public opening hours in order to qualify as private operating foundations. The Law does not include this change. Finally, a proposal to change the excess business holdings rules under Code section 4943 to add an exception that would allow a private foundation to hold all of the ownership interests in a charitable business enterprise that distributes all of its net operating income to the private foundation is not included in the Law.

- In the excess benefit transaction area, a proposal would have eliminated the "rebuttable presumption" of reasonableness safe harbor under Code section 4958. This change is not included in the Law.
- In the UBIT area, a proposal would have treated certain income from the licensing of the name or logo of a tax-exempt organization as UBTI. The Law does not make any change to the treatment of this licensing income.
- In the donor-advised funds area, one proposal would have imposed additional reporting requirements on sponsoring organizations of donor-advised funds relating to annual distributions and grant recommendation policies. The Law makes no change to the reporting requirements for sponsoring organizations of donor-advised funds.
- In the charitable contributions area, a proposal would have required the determination of the cost basis of specified securities on a first-in first-out basis without regard to specific identification of the securities. This basis determination would have applied for all purposes, including charitable contributions of securities. The Law does not make any change to the current law, which allows for specific identification by the taxpayer.

Conclusion

The Law includes several important changes for tax-exempt organizations and their donors. The total impact of these changes will become more clear as the Law's provisions are implemented and as associated Treasury Regulations are promulgated. In addition to the provisions of the Law that pertain directly to tax-exempt organizations, the Law represents a significant overhaul of the existing system of taxation in the United States. Therefore, other provisions, including changes to the individual and corporate tax rates and available deductions, are likely to have an indirect impact on tax-exempt organizations. Furthermore, several of the proposals related to tax-exempt organizations that are not included in the Law had been proposed prior to this latest comprehensive tax reform effort. It is possible that the substance of those proposals will be included in other future legislative efforts, and it is important for tax-exempt organizations to be aware of them. We are available to discuss the Law and its impact, and we will continue to monitor developments in this area.

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