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Federal Tax



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Federal Tax Reform — Key Provisions for Tax Exempt Organizations

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (H.R. 1), or the "Act," a comprehensive tax reform package representing an overhaul of federal taxation arguably on a level not seen in more than 30 years. The sweeping piece of legislation makes the following significant changes affecting tax-exempt organizations:

REDUCTION IN TAX RATES

One of the key provisions of the Act is the reduction in corporate and individual tax rates. The Act eliminates the graduated corporate rate structure with a maximum graduated rate of 35 percent and instead taxes corporate taxable income—and therefore, any unrelated business taxable income (UBTI) earned by tax-exempt organizations—at 21 percent effective for taxable years beginning after December 31, 2017. In addition, the Act replaces the existing tax rate structure applicable to ordinary income earned by individuals with a new rate structure with a maximum graduated rate of 37 percent (for married individuals filing jointly), which sunsets in taxable years beginning after December 31, 2025. The Act generally retains the present-law maximum rates on net capital gain and qualified dividends earned by individuals.

REDUCED INCENTIVES FOR INDIVIDUAL CHARITABLE GIVING

The Act did not alter the charitable deduction or the mechanism by which individual taxpayers can report such deductions as itemized deductions. The Act did temporarily increase (for tax years beginning after December 31, 2017, and before January 1, 2026) the maximum charitable contribution of cash by an individual to certain public charities as private operating foundations from 50 percent to 60 percent of the individual's adjusted gross income. Nevertheless, the Act includes changes to the individual standard deduction and the estate and gift tax exemption that may disincentivize individual charitable giving.

For tax years beginning after December 31, 2017, and before January 1, 2026, the Act raises the standard deduction from \$6,350 to \$12,000 for unmarried individuals, and from \$12,700 to \$24,000 for married couples (these numbers will be adjusted for inflation). The increased standard deduction may reduce the number of individuals who receive a tax benefit from their charitable giving because individuals may be less inclined to itemize their deductions.

The Act also doubles the basic estate and gift tax exemption for estates of decedents and gifts made after December 31, 2017, and before January 1, 2026, from \$5 million to \$10 million (these numbers

are indexed for inflation after 2011; the 2018 exclusion is expected to be approximately \$11.2 million).

EXCISE TAX ON EXCESS COMPENSATION

As we previously reported [here](#), the Act imposes an excise tax on "excess compensation" paid by tax-exempt organizations to "covered" employees. A covered employee is defined as any current or former employee who is one of the five highest paid employees for the tax year, or who was a covered employee for any prior year beginning after December 31, 2016. The excise tax is payable by the exempt organization (not the employee) at the new corporate tax rate of 21 percent. Excess compensation is generally defined as remuneration in excess of \$1 million, plus any excess parachute payments paid in a taxable year. Compensation paid by related entities is also added to the calculation of total remuneration such that the excise tax may be pro-rated among the various employers in proportion to the remuneration paid by each. Health care entities may note that compensation attributable to medical services provided by licensed medical professionals is excluded from the excise tax.

EXCISE TAX ON INVESTMENT INCOME OF CERTAIN PRIVATE COLLEGES AND UNIVERSITIES

Historically, private colleges and universities generally have not been subject to excise taxes on their net investment income. Certain private colleges and universities with significant endowments will now be subject to a 1.4 percent excise tax on their investment income. The definition of net investment income is designed to correspond to the same definition under the private foundation rules. The excise tax applies to private colleges and universities with both assets of more than \$500,000 per full time student (excluding assets used to carry out the institution's exempt purposes) and 500 or more students, at least 50 percent of whom are located in the United States. The assets and net investment income of related organizations (e.g., supporting and supported organizations) generally are treated as the assets of the college or university. State colleges and universities are not subject to the excise tax.

UNRELATED BUSINESS TAXABLE INCOME (UBTI) CALCULATED SEPARATELY FOR EACH TRADE OR BUSINESS

Exempt organizations engaged in business activities that are unrelated to their exempt purposes generally are taxed on the income from those business activities. Under the prior law, organizations that engaged in more than one unrelated trade or business determined their UBTI in the aggregate, by calculating the gross income from all businesses, less any permissible deductions. The Act amends Section 512(a) of the Internal Revenue Code to require that UBTI be calculated separately for each unrelated trade or business, which will prevent exempt organizations from applying losses or deductions from one business to offset income from another. Net operating loss carryovers from years prior to January 1, 2018 can still be used to reduce all UBTI, regardless of the trade or business to which it relates. The Act does not provide any guidance on how to allocate and/or apportion expenses among UBTI-generating activities, nor how to distinguish between trades or businesses for separately calculating UBTI.

For more information, or if you have questions about how the issues raised in this legal update affect your policies, practices, or other compliance efforts, please contact one of the following lawyers in the firm's [Tax-Exempt Organizations](#) Group:

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