Exempt organizations: Costs of tax reform

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The Tax Cuts and Jobs Act (the act), signed into law on December 22, 2017, represents a significant tax reduction for individuals and businesses. To partially offset these cuts, however, the act establishes more stringent rules in other areas, including stricter rules for calculation by exempt organizations of unrelated business taxable income (UBTI) and several new narrowly targeted excise taxes on exempt organizations. Consequently, exempt organizations (especially those operating more than one unrelated trade or business) should plan for additional costs and review their current organizational structure to ensure that it is still the most tax efficient model.

Separate calculation of UBTI for each trade or business

Section 13702 of the act provides a new method of computing UBTI. Under prior law, exempt organizations calculated UBTI on an organizational-wide basis, meaning the revenues and deductions for each separate trade or business were aggregated to determine the organization’s total UBTI. The statute now requires organizations with more than one unrelated trade or business to calculate UBTI separately for each line of business. The new provisions are essentially loss limitation rules, as losses from one line of business may no longer be used to offset income from more profitable lines of business. Importantly, transitional relief under the act provides that net operating losses arising prior to January 1, 2018, are not subject to the new UBTI rules.

Excise tax on executive compensation

Section 13602 of the act imposes an excise tax on exempt organizations for compensation paid to executives. Historically, rules against private inurement and excess benefit transactions were the primary limitations on compensation paid by exempt organizations. These rules were generally satisfied if executives were compensated at no more than fair market value. Under the act, an excise tax may apply to an exempt organization even if compensation does not exceed fair market value. The new statute provides that payments in excess of $1 million per year made to a "covered employee" are subject to tax at corporate rates. A covered employee is any of the organization's five highest compensated employees during the current year, or any prior year beginning after December 31, 2016.

In addition to compensation payments in excess of $1 million, the new excise tax also applies to certain parachute payments made to executives upon termination of employment. Exempt organizations should make sure that any such arrangements are carefully structured to limit exposure to the new tax.

Private colleges and universities: Investment income excise tax

Section 13701 of the act imposes a new excise tax on the investment income of certain private colleges and universities. This new excise tax essentially parallels a tax already imposed on the investment income of private foundations under section 4940 of the Internal Revenue Code of 1986 (the code). Over the years, most private colleges and universities avoided the tax under section 4940, because they are generally organized as public charities (as opposed to private foundations) under section 509(a) of the code. The act now subjects certain private colleges and universities to a 1.4 percent investment income tax, despite their public charity designation. The tax, however, only applies to private schools with very large endowment funds. Specifically, it only applies if the fair market value of a private school's assets at the conclusion of the prior year, excluding assets used in carrying out the institution's exempt purposes, equates to at least $500,000 per enrolled student.

Unfortunately, the statute provides only a bare-bones outline of the new investment income tax. Regulations are needed to establish several critical issues. For example, the Department of Treasury is expected to issue rules for determining whether an asset is used in furtherance of a school's exempt purpose and is, thus, excluded from the tax's threshold calculation.

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