# WELCOME

## Tax Reform Session

Presented by the Nonprofit and
Tax-Exempt Practice

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# Tax Cuts & Jobs Act:
# Select Non-Profit Tax Issues

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# Tax Cuts and Jobs Act (“TCJA”): Introduction

The recently enacted **Tax Cuts and Jobs Act ("TCJA")** is a sweeping tax package. This presentation will provide an overview of some of the more important business tax changes in the new law. Unless otherwise noted, the changes are effective for tax years, beginning in 2018.

# Take-Aways

# Take Aways

- Tax Law expected to impact charitable giving by a $13 billion reduction from individual income tax changes and a $4 billion reduction from estate and gift tax law changes
- Anticipate conversations with HNW donors regarding decreased or eliminated charitable bequests
- Consider changing the conversation with donors — help them realize the financial benefit to you and to them in considering certain types of donations, particularly low basis assets
    - Huge impact for the organization with the benefit to the donor that she can diversify her portfolio at a relatively low, non-cash economic cost
- Consider whether assets generating UBTI might be worth the associated tax cost
- Watch out for fringe benefits that might generate UBTI, excess compensation to executives and other highly compensated employees and consider whether you might be subject to the net investment income excise tax applicable to private colleges and universities

# Individual Tax Rates, Exemptions and Deductions: The Problem for Charitable Giving

# Individual Tax Rates

Individual tax rates also reduced; those new rates are as follows, courtesy of the Tax Foundation:

**Tax Brackets and Rates, 2018**

| Rate | For Unmarried Individuals, Taxable Income Over | For Married Individuals Filing Joint Returns, Taxable Income Over | For Heads of Households, Taxable Income Over |
|---|---|---|---|
| 10% | $0 | $0 | $0 |
| 12% | $9,525 | $19,050 | $13,600 |
| 22% | $38,700 | $77,400 | $51,800 |
| 24% | $82,500 | $165,000 | $82,500 |
| 32% | $157,500 | $315,000 | $157,500 |
| 35% | $200,000 | $400,000 | $200,000 |
| 37% | $500,000 | $600,000 | $500,000 |

# Standard Deduction; Child Tax Credit

Standard Deduction doubled under the new law;
Child tax credit is expanded.

Individuals now get a $12,000 standard deduction; married couples, a $24,000 deduction.

And people with children qualify for $2,000 child tax credit, a portion of which is refundable (phase-outs apply).

BUT

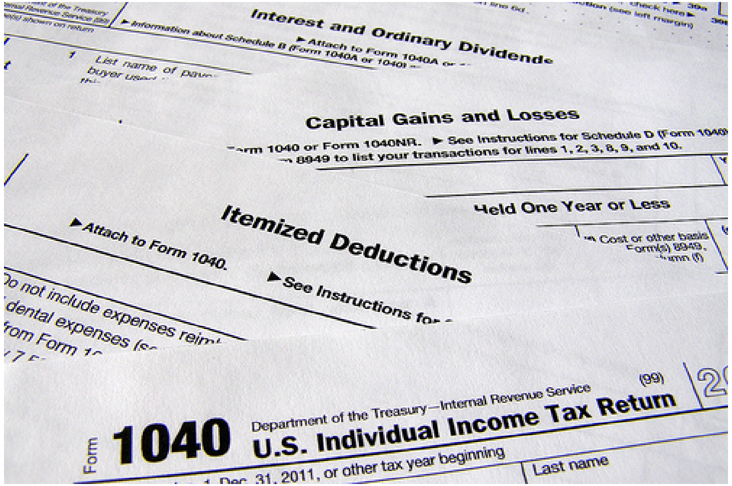
# Personal Exemptions; Itemized Deductions

## Personal Exemptions

- Phased out until 2026

## Itemized Deductions

- State and local tax deduction limited to $10,000 BUT the limitation does not apply to state and local income or personal property tax arising from trade or business operation or investment activity
- Other limitations apply



# Potential Impact on Non-Profit Giving: Example

- Family of 4 (2 parents, 2 Children)
- Combined Household Income of $150,000 / year
- House worth $250,000 with $200,000 Mortgage @ 3.5% Interest
- $4,000 Real Estate Tax
- $730 / month of Mortgage Interest = $8,760 / year
  - Total Payment would be ~ $1,122; Assume another $1,000 / year home insurance
- 3% PA Income Tax = $4,000 / year
- Total Itemized Deductions of $17,360 / year w/o Non-Profit Giving

# Potential Impact on Non-Profit Giving, continued

- Contrast with $24,000 Standard Deduction
  - Before tax reform the deduction was a $12,000 deduction PLUS four personal exemptions of $4,000 each (total reduction of $28,000)
  - BUT you could use the personal exemptions even if you itemized
- To match the standard deduction, need $6,640 / year of Non-Profit Giving OR $553 / month
- With Standard Deduction, FIT = ((10% x 19,050) + (12% x $58,350) + (22% x $48,600)) – 2 Child Tax Credits of $2,000 = $17,599 (assumes no refundable portion)
- Cash Out of Pocket w/o other Living Expenses = $150,000 - $4,000 PA Real Estate Tax - $4,500 PA Income Tax - $13,464 Mortgage Payments - $1,000 Insurance - $17,599 = **$109,437 before other basic living expenses taken into account**

# Potential Impact on Non-Profit Giving, continued

- What's not taken into account:
  - Retirement Deductions (@5% = $7,500)
  - Health Insurance ($1,500 Premium with 1/3 employer contribution = $1,000 Out of Pocket / mo. Or $12,000 / year)
  - College Savings Plan ($100 / month / child = $200 / mo. or $2,400 / year)
  - Car Payments, Gas & Maintenance ($500 / mo. x 2.5 = 1,250 / mo. or $15,000 / year)
- **Now down to $72,537 per year**
- Layering in top social security and Medicare taxes ***reduces this by another $15,000 to $57,537***…

# Potential Impact on Non-Profit Giving, continued

- What's still not taken into account: food and other household items ($2,000 per month or $24,000 per year), clothing ($12,000 per year), utilities ($5,000 per year), home maintenance expenses ($1,500 per year), other savings, family vacation ($2,500 per year), holiday/birthday/anniversary gifts, private school tuition ($10,000 per year per child at least), children's activities ($5,000 per year), church tithing ($3,000 per year)…
- Under these numbers, and ***not including*** other savings, gifts or private school tuition, ***this family's net annual cash flow is reduced to $4,537***…
- National Council on Nonprofits estimates that this could reduce giving to nonprofits by $13 billion per year at a cost of up to 264,000 nonprofit jobs

# Personal Alternative Minimum Tax

**The Personal Alternative Minimum Tax STILL EXISTS!**

But certain thresholds have been increased, which should reduce the taxpayers subject to this dreaded tax!

Limitations under the AMT will further reduce the tax benefit for charitable giving for many taxpayers.

# Estate & Gift Tax Exclusion

- Years ago: Charitable Giving Reduced Exposure to the modest $1,000,000 Estate & Gift Tax Exclusion
- Estate & Gift Tax Phased Out in 2010 and then returned but with $5.4 million exclusion (~$11 million for husband and wife)
- Now = $11.2 million PER Spouse for total of $22.4 million per husband and wife
  - Effectively, husband and wife can give $22.4 million of wealth to children, family and friends without implicating estate and gift tax
- Removes Incentive to use charitable giving as a way to reduce exposure to estate and gift taxes — National Council on Nonprofits estimates that ***this could cost nonprofits $4 billion annually through reduced contributions***

# Is there a solution?
# Focus on HNW / High Income Donors

# Increased Charitable Deductions for High Income Earners

Before the TCJA, high income earners capped out at 50% of the donor's adjusted gross income and were subject to certain phase outs referred to as the Pease Limitation (could not deduct until total itemized deductions equaled 2% of AGI and were subject to a phase-out)

***Now the Pease Limitation is suspended and donors can make donations up to 60% of their AGI.***

***Thus, High Income Earners, who likely will itemize because their mortgage interest and other deductions will exceed the standard deduction, get an extra bump in making charitable contributions compared to previous years…***

# Think of Yourself as a Tax Advisor…

- Other tax and financial benefits exist for making a charitable contribution
  - Classic Example: low-basis stock
    - 10,000 Shares of Amazon Stock @ $100 / Share ($1,000,000 Investment)
    - Shares now worth $14,050,000 (based on 4/6 closing price of $1,405)
    - Embedded Taxable Gain of $13,050,000 with potential tax of $2,610,000

# Think of Yourself as a Tax Advisor… Continued

- Donor can receive charitable deduction at full fair market value of the stock
  - Contribution of 1,000 shares = $1,405,000 deduction for the Donor
  - If fully deductible, deduction has cash value of $520,000 to donor because of the income tax reduction
  - Based on value of stock and basis, the economic cost of the deduction for the taxpayer is $624,000 but you get donation of $1,405,000: WIN-WIN

# Think of Yourself as a Tax Advisor… Continued

- Show the Work
- Contribution of 1,000 shares = $1,405,000 deduction for the Donor
- If fully deductible, deduction has cash value of $520,000  (that is, 37% x $1,405,000)
- Economic Value of Stock = $1,405,000 – [Tax = ($1,405,000 -$100,000 cost basis) x 20% Capital Gain Tax Rate] = $1,144,000
- Economic Cost of Deduction = Economic Value of Stock ($1,144,000) – Economic Value of Deduction ($520,000) = $624,000
  - Why? Because of the Charitable Deduction, the donor can reduce his other taxes by $520,000, which is set-off against the economic value in the stock she is giving up by making the donation… So the cost of the deduction is just a bit more than 1/3 the value of the donation to your organization

# Think of Yourself as a Tax Advisor… Continued


- Bonus Result: Portfolio Diversification
  - Donations of highly-appreciated stock help taxpayers remove concentrated stock positions and free up cash (through tax savings generated by the charitable deduction) to diversify their stock portfolio
  - Consider using this example with donors…



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# Think of Non-Traditional Assets

- You are probably used to receiving traditional types of donations: cash and publicly traded stocks and securities
- Consider receiving assets that might generate unrelated business taxable income but which also might generate significant cash flow…
- Why now? Because the TCJA has lowered the tax on corporations to 21%...
  - Before, UBTI was taxed at 35%, the tax rate for corporations
  - TCJA lowered this to a flat 21% -- that 14% differential may provide enough of a benefit to pay for the increased administration sometimes required by these types of assets…

# Think of Non-Traditional Assets

**What are these types of assets?**

- Real estate fund investments;
- Private Equity Fund Investments;
- Even private company stock;
- Buildings and other real estate such as parking facilities;
- Land development interests

# Excess Business Holdings: Newman's Own Rule & Private Foundations

- Private Foundations may now own 100% of an operating business entity without being subject to excise tax of Section 4943…
- All profits of the business must go to charity
- Beware: Profits from business holdings may still be subject to UBTI if deductible payments made from the business entity (in the case of a corporation) or the amount of profits allocated to the foundation would be UBTI directly (in the case of a pass-through business entity)
- If the business is a flow-through, the foundation will pay tax on the UBTI; if a corporation, the business will pay corporate income tax at 21%... Why would you do this?
  - Because doing so achieves an effective federal income tax rate of 21% on all income and, in the case of a corporation, eliminates any tax on the dividends
  - ***A wealthy family owning a closely-held business could transfer wealth to the foundation such that the income of the business is taxed at 21% and does not have to first be taxed at a rate of at least 37% and then transfer the net result to the foundation…***

# Special Issues

# Excise Tax on Excess Compensation

- Excess Tax Applies to “so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of $1,000,000, plus (2) any excess parachute payment paid by such an organization to any covered employee”
- Tax = 21% of that excess compensation and is paid by the employer
- Covered Employee: “one of the 5 highest compensated employees of the organization for the taxable year, or was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016”
- Generally applies to any 501(c)(3) non-profit organization

# Excise Tax on Investment Income of Private Colleges and Universities

- Perception that certain private colleges and universities are investment funds that happen to also run a college or university…
- Excise Tax = 1.4% of Net investment Income (investment income and capital gain over allowable deductions) of the Institution
  - Applicable Educational Institution: Institution described in Section 481 of Higher Education Act of 1965 and eligible to participate in a program under title IV of such Act -- All accredited public, nonprofit, and proprietary postsecondary institutions
    - 500 Students in Previous Taxable Year
    - >50% located in USA
    - Not a State College or University
    - FMV of assets ≥ $500,000 per student of the institution (so at least $25,000,000 in assets)
- As your assets grow: be careful that this provision does not apply to you…

# UBTI Issues: Fringe Benefit Expenses

- UBTI for organization increased by certain qualified transportation fringe benefits, any parking facility used in connection with qualified parking, or any on-premises athletic facility
    - Transit pass, expense reimbursement for travel from home to work in commuter vehicle; bicycle reimbursement
    - On-premise athletic facility operated by employees and mostly used by employees or their relatives

# UBTI Issues: Calculation of Tax on Activity by Activity Basis

- UBTI must be calculated—and is assessed—on each unrelated business activity engaged in by the Non-Profit

- Non-Profits cannot aggregate loss producing activities with income producing activities to arrive at a net loss or break-even on UBTI
  - Thus, even an overall loss on all unrelated business activities, non-profit may still have UBTI and have to pay the associated tax

# Biography

# Michael G. Dana

Michael is a Director and a member of the Corporate and Tax Group. He focuses his practice on providing U.S. tax advice to businesses and their owners—in connection with all aspects of business formation, operation and disposition.

Michael's diverse practice also includes advising clients on corporate, partnership, securities and other business law matters.

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**Notable successes of Michael's include:**

- Assisting Registered Investment Adviser in connection with launch of strategic hedge fund
- Representing client in the tax aspects of the sale of its business for a total transaction price of approximately $75 million to a private equity buyer
- Implementing a domestic hedge fund using a series limited liability company that closed with $15.6 million in initial capital
- Implementing a $250 million mezzanine fund focused on investments in the franchised food business
- Representing a foreign beer manufacturer in its first joint venture with a domestic beer brewery
- Advising US subchapter S corporation regarding the restructuring of a Canadian acquisition resulting in significant annual tax savings for the client
- Identifying an increase available to a client in the net operating loss limitation of an acquired corporate subsidiary by approximately $2 million annually

# Thank You

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