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House GOP Tax Reform Bill Includes Provisions That Would Impact Exempt Organizations

The House Committee on Ways and Means on November 2 released H.R. 1, the “Tax Cut and Jobs Act,” the long-awaited GOP tax reform bill. The House bill proposes several significant changes in federal tax laws governing exempt organizations. During the committee’s markup, Chairman Kevin Brady (R-Texas) offered an amendment to his chair’s mark, revising (among other provisions) the proposal to tax investment income on certain college and university endowments. That amendment passed in a roll call vote on November 6.

We will continue to analyze and provide updates regarding tax reform proposals as they move through the House and Senate. For now, we offer the following brief summary of key provisions to watch, along with our insight regarding the potential impact on our exempt organization (EO) clients.

Executive Compensation

The House bill proposes to add a new excise tax provision to Chapter 42 to parallel the \$1 million deductibility limitation under IRC § 162(m) for executive compensation paid by publicly traded companies. New IRC § 4960 would impose a 20-percent excise tax on compensation of more than \$1 million paid by EOs to any of their top-five highest-paid employees. For these purposes, compensation or “remuneration” would include all wages, including benefits, except for Roth contributions and benefits excluded from gross income.

Charities and social welfare organizations exempt under IRC §§ 501(c)(3) and 501(c)(4), respectively, are accustomed to setting limits on executive compensation, based on market benchmarking, as they are both covered by the provisions governing “excess benefit transactions” set forth in IRC § 4958. The House Bill proposes to cast a wider net. The following categories of EOs would be subject to the proposed penalties:

- All organizations exempt from taxation under section 501(a) — this includes labor unions, trade associations, and other 501(c) exempt organizations.
- Organizations whose income is excluded under section 115(1) — this could include some state colleges and universities.
- Political organizations under section 527(e)(1).
- Farmers’ cooperatives exempt under section 521(b)(1).

Penalties imposed under IRC § 4958 are assessed against the executives who receive excessive compensation and on any EO managers who knowingly approve it. The new tax under proposed IRC § 4960 would be assessed against the employer EO. In a state with active Attorney General oversight, the Attorney General may seek to surcharge the directors for such tax.

The proposal would apply to compensation paid to any current or former employee who is (1) one of the five highest compensated employees of the organization during the tax year, or (2) one of the highest compensated employees of the organization during any preceding taxable year beginning after December 31, 2016. Here again, the proposal is broader in scope than IRC § 4958, which only applies to “disqualified persons.” In the higher education context, for example, certain faculty members and athletic coaches may make the top-five list for purposes of this new tax, but may not exercise the requisite “substantial influence” over an institution’s affairs to be considered a “disqualified person” under IRC § 4958.

Significantly, the definition of remuneration would include compensation paid by organizations related to a covered

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EO, and the excise tax would be assessed against all related employers in proportion to the amount of compensation paid by each. An organization is considered related if it:

- Controls or is controlled by the tax-exempt organization.
- Is controlled by one or more persons that control the tax-exempt organization.
- Is a supported organization.
- Is a supporting organization under section 509(a)(3).
- In the case of section 501(a)(9) voluntary employees' beneficiary association (VEBA), establishes, maintains, or contributes to the VEBA.

Non-Qualified Deferred Compensation

Under the House bill, an employee would be taxed as soon as there is no substantial risk of forfeiture with regard to that compensation (i.e., not contingent upon the employee's future performance of substantial services).

Unrelated Business Income Tax (UBIT)

The House bill would amend IRC § 511 to clarify that state and local entities — including public pension plans — are subject to UBIT even if their income is excluded under IRC § 115.

Private Foundations

The House bill makes a couple of changes to the excise taxes assessed on private foundations. First, the House bill proposes to replace the current two-tier private foundation excise tax on net investment income (IRC § 4940) with a single rate of 1.4 percent.

Second, beginning in 2018, the IRC § 4943 tax on “excess business holdings” would be modified to permit foundations to own and control certain philanthropic for-profit businesses, provided that (1) the foundation must hold all of the voting stock of the business; (2) the foundation must acquire the business by means other than by purchase (i.e., by gift or bequest); (3) the business must distribute all of its annual net operating income to the foundation within 120 days of the close of each tax year; (4) the directors, officers, trustees, or employees of the business, or their family members, are not “substantial contributors” to the foundation; (5) directors and officers of the business, or members of the family of substantial contributors, do not make up a majority of the foundation's board; and (6) no

loan is outstanding from the business to a substantial contributor or a family member of a substantial contributor.

Provisions Specific to Higher Education

The House bill would impose a 1.4-percent excise tax on net investment income (endowment earnings) of private colleges and universities that have (1) at least 500 students, and (2) assets (other than those used directly in carrying out the institution's educational purposes) valued at the close of the preceding tax year of at least \$250,000 per full-time student.

The bill would eliminate two tax provisions that enable employers in higher education to provide reduced cost and tax-free educational benefits to their employees and graduate students — namely, IRC § 117(d) (qualified tuition reduction for employees, spouses and dependents) and IRC § 127 (employer-provided educational assistance program).

Tax-Exempt Bonds

The House bill would tax interest on “private activity bonds” beginning on January 1, 2018. Among other measures, the proposal would eliminate IRC § 145, which provides for “qualified 501(c)(3) bonds.” This is the category of bonds that colleges and universities, hospitals and health care organizations, and other 501(c)(3) organizations depend on to finance construction, renovations, and capital improvements of campus buildings and facilities.

Modification of the Johnson Amendment

Under current law, all organizations exempt under IRC § 501(c)(3) — including churches — are prohibited from participating in, or intervening in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. This prohibition was added to IRC § 501(c)(3) in an amendment proposed by then-Senator Lyndon B. Johnson in 1954. The House bill proposes to carve out an exception for political statements made by churches and other houses of worship in the ordinary course of their religious activities.

More specifically, the House bill proposes to amend IRC § 501 to provide that an organization will not fail to be considered organized and operated exclusively for religious purposes, and will not be deemed to have participated in, or intervened in any political campaign, solely because of the content of any homily, sermon, teaching, dialectic, or other presentation made during religious services or gatherings. The exception will only apply if the preparation and

presentation of such content is “in the ordinary course of the organization’s regular and customary activities” and “results in the organization incurring not more than de minimis incremental expenses.” The House bill does not define any of these terms or thresholds.

Donor Advised Fund (DAF)—Policy and Reporting Requirements

Under current law, a charity that maintains DAF accounts must report on a schedule to its annual Form 990 the total number of DAFs it owns, the aggregate value of the assets held in the DAFs, the aggregate contributions made into the DAFs during the year, and the aggregate grants made out of the DAFs during the year. The House bill would add additional reporting requirements so that DAF sponsoring organizations must also report (1) the average amount of grants made from their DAFs during the year, expressed as a percentage of value of assets held at the beginning of the tax year, and (2) whether the organization has a policy with respect to DAFs for frequency and minimum level of distributions. The sponsoring organization would also be required to provide a copy of the policy.

If you have any questions about how the House bill proposals would affect your exempt organization or its officers, directors, employees or donors, please do not hesitate to call a member of our [Nonprofits and Tax-Exempt Organizations practice group](#).

Loeb & Loeb LLP’s Nonprofits and Exempt Organizations Practice

Loeb & Loeb’s leading national Nonprofits and Tax-Exempt Organizations Practice offers the full spectrum of services to help nonprofit organizations grow, innovate and succeed in the face of increasing regulatory and marketplace challenges. Our distinguished practice team includes some of the nation’s leading nonprofit legal authorities, including former top regulators at the federal and state levels, offering unique insight and regulatory perspective that do not exist elsewhere.

The nonprofit legal landscape is challenging for even the most sophisticated organizations. Our experienced lawyers offer skilled guidance on what tax-exempt entities need to know to stay compliant with both federal and state legal requirements. Our core nonprofit practitioners work closely with the firm’s other leading practices — corporate, trusts and estates, litigation, intellectual property, advertising and promotions, real estate, digital media and technology, executive compensation, and employment law — to provide our clients with a truly integrated platform at an exceptional value.

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Loeb & Loeb's Nonprofits and Exempt Organizations Practice

MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
LAURA B. BERGER	LBERGER@LOEB.COM	310.282.2274
LEAH M. BISHOP	LBISHOP@LOEB.COM	310.282.2353
TARIN G. BROSS	TBROSS@LOEB.COM	310.282.2267
RYAN T. COURT	RCOURT@LOEB.COM	312.464.3186
REGINA I. COVITT	RCOVITT@LOEB.COM	310.282.2344
LINDA N. DEITCH	LDEITCH@LOEB.COM	310.282.2296
PAUL N. FRIMMER	PFRIMMER@LOEB.COM	310.282.2383
ELIOT P. GREEN	EGREEN@LOEB.COM	212.407.4908
RACHEL J. HARRIS	RHARRIS@LOEB.COM	310.282.2175
DIARA M. HOLMES	DHOLMES@LOEB.COM	202.618.5012
DAVID V. KHANJYAN	DKHANYAN@LOEB.COM	310.282.2394
JORDAN A. KLEIN	JKLEIN@LOEB.COM	312.464.3120
JASON R. LILIE	JLILIE@LOEB.COM	212.407.4911
CAMILLE LU	CLU@LOEB.COM	312.464.3185

TALIA G. METSON	TMETSON@LOEB.COM	212.407.4285
ANNETTE MEYERSON	AMEYERSON@LOEB.COM	310.282.2156
DANIELLE E. MILLER	DEMILLER@LOEB.COM	310.282.2083
VICTORIA P. MORPHY	VMORPHY@LOEB.COM	212.407.4172
MARCUS S. OWENS	MOWENS@LOEB.COM	202.618.5014
RONALD C. PEARSON	RPEARSON@LOEB.COM	310.282.2230
ALYSE N. PELAVIN	APELAVIN@LOEB.COM	310.282.2298
TZIPPORAH R. ROSENBLATT	TROSENBLATT@LOEB.COM	212.407.4096
CRISTINE M. SAPERS	CSAPERS@LOEB.COM	212.407.4262
KATHLEEN O'HAGAN SCALLAN	KSCALLAN@LOEB.COM	312.464.3112
JENNIFER TAM	JTAM@LOEB.COM	202.618.5023
STUART P. TOBISMAN	STOBISMAN@LOEB.COM	310.282.2323
JESSICA C. VAIL	JVAIL@LOEB.COM	310.282.2132
DANIEL M. YARMISH	DYARMISH@LOEB.COM	212.407.4116