

## Insight

## Tax Reform Discussion Draft Holds a Host of Changes for Not-for-Profits

by Patty Mayer, Senior Manager, Not-for-Profit Practice

The discussion draft for the Tax Reform Act of 2014, released by the House Committee on Ways and Means, suggests many changes that would directly affect tax-exempt organizations. Several of the draft's provisions would affect tax-exempt organizations of all types; others focus on private foundations and institutions of higher education. Unless otherwise noted, the changes would be effective for tax years beginning after 2014. Let's take a closer look at what the discussion draft proposes.

### Excess Executive Compensation

Tax-exempt organizations would be subject to a 25 percent excise tax on compensation in excess of \$1 million paid to any of its five highest paid employees for the tax year. The tax would apply to all remuneration paid to a covered person for services, including the cash value of benefits other than tax-qualified retirement plans and amounts that are excludable from the executive's gross income.

### Repeal of Type II and Type III Supporting Organizations

If an organization does not qualify as a Type I supporting organization, it would be treated as a private foundation.

### Tax-Exempt Bond Financing

Organizations with Internal Revenue Code (IRC) section 501(c)(3) status that qualified for private activity bonds would not be eligible to borrow

on a tax-exempt basis. This provision would be effective for bonds issued after 2014.

### Modification to Intermediate Sanctions

A 10 percent excise tax would be imposed on the tax-exempt organization when a tax is imposed on a disqualified person unless minimum standards of due diligence have been met.

The intermediate sanctions excise tax would be expanded to include not only IRC section 501(c)(3), (4), and (29) organizations but also IRC section 501(c)(5) and (6) organizations.

### Excise Tax on Failure to Distribute Contribution to Donor-Advised Fund Within Five Years

Donor-advised funds would be required to distribute contributions to public charities within five years of receipt. Failure to make an eligible distribution would subject the sponsoring charitable organization to an annual excise tax equal to 20 percent of the undistributed funds. This provision would be effective for contributions made after 2014. For contributions made before 2014 that remain in the donor-advised fund on January 1, 2015, the five-year distribution period would begin on January 1, 2015.

### Mandatory Electronic Filing

Only tax-exempt organizations that file at least 250 returns (that is, Forms W-2 for employees and Forms 1099 for certain service providers)

during the calendar year are currently required to e-file their annual tax return (Form 990) with the IRS. The draft would require all tax-exempt organizations that file Form 990-series returns to file electronically.

### Unrelated Business Income Tax

The provisions clarify that all entities exempt from tax under IRC section 501(a) would be subject to UBIT rules, regardless of whether the entity is exempt under another provision of the code (for example, public pension plans and state colleges or universities).

#### Name and Logo Royalties

Any sale or licensing by a tax-exempt organization of its name or logo (including any related trademark or copyright) would be treated as an unrelated trade or business, and royalties paid with respect to such licenses would be subject to UBIT.

#### UBIT Computed Separately for Each Activity

A tax-exempt organization would be required to calculate separately the net unrelated taxable income of each unrelated trade or business. In addition, any loss derived from an unrelated trade or business could be used only to offset income from that particular unrelated trade or business, with any unused loss subject to the general rules for net operating losses.

#### Research Income Exclusion Limited to Publicly Available Research

The exception from the UBIT rules for fundamental research would be limited to income derived from research made available to the public. Thus, income from research not made publicly available would be treated as unrelated trade or business income and subject to the UBIT rules.

#### Parity of Charitable Contribution Limitation Between Trusts and Corporations

Under the provision, charitable contributions, for purposes of determining UBIT, would be limited to 10 percent of the unrelated business taxable income, regardless of whether the contributing entity is organized as a corporation or a trust.

#### Increased Specific UBIT Deduction

The deduction (currently \$1,000) would be increased to \$10,000.

### Qualified Sponsorship Payments

The UBIT exception for qualified sponsorship payments would be modified in two respects. First, if the use or acknowledgment refers to any of the business sponsor's product lines, the payment would be treated as advertising trade or business—which is a per se unrelated trade or business. Second, if a tax-exempt organization receives more than \$25,000 in qualified sponsorship payments for any one event, any use or acknowledgment of a sponsor's name or logo may only appear with—and in the same manner as—the names of a “significant portion” of the other donors to the event.

#### Manager-Level Penalty on Underpayment of UBIT

A 5 percent penalty (up to \$20,000) would apply to the managers of a tax-exempt organization when an accuracy-related penalty is assessed to the organization for any substantial understatement of UBIT. The provision also would apply a 10 percent penalty (up to \$40,000) on managers of a tax-exempt organization for an understatement of UBIT relating to a reportable or listed transaction.

#### Corporate Tax Rate

The tiered tax rates would be replaced with a flat 25 percent rate beginning in 2019. A transition rule would set the rate for taxable income up to \$75,000 to 25 percent beginning in 2015.

#### Net Operating Losses

The net operating loss rules would change for not-for-profits organized as corporations to limit the carryover or carryback only to the extent of 90 percent of the corporation's taxable income.

### Provisions Affecting Employers

#### Employer-Provided Housing

The exclusion for housing provided by an employer for employees of educational institutions would be limited to \$50,000 (\$25,000 for a married individual filing a joint return), and the exclusion would be limited to one residence.

#### Moving Expenses

Under current policy, a taxpayer may claim a deduction for moving expenses incurred in connection with starting a new job if certain

distance requirements are met. The draft repeals this deduction, which affects an employer's ability to reimburse these expenses tax-free for new or existing employees.

### **Exemptions from FICA**

The exceptions from FICA tax for foreign agricultural workers, foreign students, and foreign participants in international cultural exchange programs would be repealed. The FICA exception for students would be limited to the student's earnings that are less than the amount needed to receive a quarter of Social Security coverage for the year (\$1,200 for 2014).

### **Worker Classification**

The draft proposes a safe harbor for classifying a worker as an independent contractor. To qualify, the worker would have to satisfy certain sales or service criteria and have a written agreement meeting specified requirements. The service recipient would withhold tax on the first \$10,000 of payments made to the worker in a year at a rate of 5 percent.

## **Provisions Affecting Specific Exempt Organizations**

### **Private Foundations**

Several additional provisions in the discussion draft apply specifically to private foundations, including a modification to the taxes for self-dealing. An excise tax of 2.5 percent would be imposed on a private foundation when the self-dealing tax is imposed on a disqualified person. The excise tax rate would be 10 percent for cases in which the self-dealing involves the payment of compensation.

Additionally, foundation managers would no longer be able to rely on the professional advice safe harbor for purposes of avoiding the manager-level tax.

The draft simplifies the excise tax on private foundations' net investment income by reducing it to a flat 1 percent rate. This provision would repeal the exception from the excise tax for exempt operating foundations.

The draft repeals the special exclusion that exempts private operating foundations from the tax for failing to distribute income. Private operating foundations that fail to do so would,

under the draft, be subject to the excise tax—as private foundations generally are.

### **Colleges and Universities**

Certain private colleges and universities would be subject to a 1 percent excise tax on net investment income. The provision would apply only to private colleges and universities with assets (other than those directly used to carry out the institution's educational purposes) valued at \$100,000 or more per full-time student at the close of the preceding tax year. State colleges and universities would not be subject to this provision.

The draft repeals the exclusion for qualified tuition reductions and employer-provided education assistance programs, which would affect benefit programs in place for employees.

### **Section 501(c)(4) Organizations**

Any organization formed after 2014 and seeking to be recognized as exempt under IRC section 501(c)(4) would be required, within 60 days of formation, to notify the IRS that it has commenced operations as a social welfare organization. Filing Form 1024 requesting formal determination of exempt status would still be optional.

The draft proposes changes to Schedule B reporting for IRC section 501(c)(4) organizations. The schedule would continue to be excluded from the public disclosure requirements.

## **Other Provisions**

### **Extension of Time to File**

Individual taxpayers would be permitted to deduct charitable contributions made after the close of the tax year but before the due date of the return (April 15) for the tax year covered by the return.

### **Adjusted Gross Income Limitations**

The AGI limitations on deductible contributions would be simplified substantially:

- The 50 percent limitation for cash contributions and the 30 percent limitation for contributions of capital gains property to public charities and certain private foundations would be harmonized at a single limit of 40 percent.

- The 30 percent contribution limit for cash contributions and the 20 percent limitation for contributions of capital gains property that apply to organizations not presently covered by the 50 percent limitation rule would be harmonized at a single limit of 25 percent.

### Two Percent Floor

An individual's charitable contributions could be deducted only to the extent they exceed 2 percent of the individual's AGI. This reduction would apply to charitable contributions in the following order: first, to contributions subject to the 25 percent of AGI limitation; second, to qualified conservation contributions; and third, to contributions subject to the 40 percent limitation.

### Value of Deduction Generally Limited to Adjusted Basis

The rules for determining the value of the deduction for contributions of property (that is, the fair market value or adjusted basis) would be substantially simplified. The amount of any charitable deduction generally would be equal to the adjusted basis of the contributed property.

For the following types of property, however, the deduction would be based on the property's fair market value less any ordinary gain that would have been realized if the property had been sold by the taxpayer at its fair market value:

- Tangible property related to the exempt donee organization's purpose Any qualified conservation contribution
- Any qualified inventory contribution
- Any qualified research property
- Publicly traded stock

In addition, in the case of inventory contributed solely for the care of the ill, needy, or infants, the provision would preserve the current rule that provides a higher valuation for the charitable deduction.

### College Athletic Event Seating Rights

The special rule that provides a charitable deduction of 80 percent of the amount paid for the right to purchase tickets for athletic events would be repealed.

### Income from Intellectual Property

Income from intellectual property contributed to a charitable organization would no longer be allowed as an additional contribution by the donor. The deduction for the contribution of the intellectual property would be retained.

### Education Incentives

There are currently 15 different tax benefits in the code relating to education. The draft proposes to streamline and simplify these benefits:

- The American Opportunity Tax Credit (AOTC), Hope Scholarship Credit, and Lifetime Learning Credit would be replaced with a revised AOTC.
- All Pell Grants would be excluded from income, regardless of how they are used.
- The exclusion of US savings bond interest, the deduction for interest on education loans, and the deduction for qualified tuition and related expenses would be repealed.
- No new contributions to Coverdell education savings accounts would be permitted. The exclusion for discharge of student loan indebtedness would be repealed.

### We're Here to Help

For more information on the discussion draft or for insight on how the proposed changes could impact your organization, contact your Moss Adams tax professional. We'll be following these issues closely, so check back for timely updates on tax reform developments.

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