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Updates for Tax-Exempt Organizations from the Senate Markup to the Tax Cuts and Jobs Act

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Over the last several days, there have been significant developments relating to the Tax Cuts and Jobs Act, the pending tax reform legislation in Congress.[1] On Thursday, a detailed summary of the Senate Finance Committee's proposal was released (the "Senate Markup"),[2] and the House Ways and Means Committee voted (in a 24-16, party-line vote) to advance their bill for consideration by the full House of Representatives (the "House Bill").[3] This alert describes certain provisions of the Senate Markup and House Bill that would have the most significant impact on the nonprofit community, including important differences between the two proposals. We described significant elements of the initial version of the House Bill last week in "New Rules for Tax-Exempt Organizations in the Tax Cuts and Jobs Act."

Unless otherwise noted, all proposals described below would be effective for taxable years beginning after December 31, 2017.

Excise tax on net investment income of private colleges and universities

The Senate Markup and House Bill both propose a 1.4% excise tax on the annual net investment income of private institutions of higher education that have assets with an aggregate fair market value of at least $250,000 per student (other than those assets which are used directly in carrying out the institution's exempt purpose) and at least 500 tuition-paying students. This new rule would effectively parallel the existing excise tax on the net investment income of private foundations. The Senate Markup, but not the House Bill, imposes the excise tax on the investment income of tax-exempt organizations related to educational institutions, as well as that of the educational institution itself.

Expansion of excise tax on tax-exempt organizations and certain highly-compensated employees

The Senate Markup and House Bill both expand the existing provisions governing excess benefit transactions (“intermediate sanctions”) for tax-exempt organizations, which result from having certain highly-paid employees. Both proposals would impose a 20% excise tax on compensation of more than $1 million paid by any tax-exempt organization to any of its top-five highest compensated employees (including all wages and many benefits but excluding payments to certain tax-advantaged retirement plans). This new rule effectively parallels the existing $1 million deductibility limitation for executive compensation paid by publicly traded companies. Notably, certain investment advisors, athletic coaches at educational institutions, as well as commissioners and other senior executives of other tax-exempt sports entities, would potentially be included among the affected employees.

The 20% excise tax to be paid by the organization would also apply to certain severance “parachute payments” that are paid to covered employees in excess of the employee’s “base amount” of compensation. “Parachute payments” are defined for this purpose as payments that are contingent upon the covered employee’s separation from the employer organization and have an aggregate present value that equals or exceeds three times the base amount. For this purpose, the “base amount” is determined by applying the current rules of section 280G, which generally provide that a covered employee’s base amount is the individual’s average annual taxable income from the organization over the five year period immediately preceding the year in which the separation from service occurs (or any shorter period of service with the organization if less than five years).

In addition, the Senate Markup would explicitly classify investment advisors and athletic coaches at most institutions of higher education as disqualified persons who are personally subject to substantial penalties on excess benefit payments (an initial tax of 25%, and a further tax of 200% if not corrected during the taxable period) where the tax-exempt organization makes payments that are deemed to exceed the value of the services provided by the disqualified person. The Senate Markup would also make several changes to the "intermediate sanctions" provisions currently applicable to public charities and social welfare organizations. It would eliminate the rebuttable presumption that compensation is reasonable if the organization follows certain procedures. Instead, those procedures would become a minimum due diligence procedure. If an excess benefit transaction occurred, the organization would be subject to a 10% excise tax on an excess benefit, unless the participation of the organization is not willful and is due to reasonable cause (this 10% excise tax will not be owed if the organization followed the minimum due diligence procedure). Finally, the Senate Markup would extend intermediate sanctions provisions to Section 501(c)(5) and 501(c)(6) organizations. The House Bill does not include these intermediate sanctions provisions.

Name and logo licensing income for tax-exempts proposed to be taxable UBTI

The Senate Markup proposes to treat royalty income derived from the licensing of a tax-exempt organization's name or logo as unrelated business taxable income ("UBTI") and thus would subject that income to tax at regular corporate or trust income tax rates. Under current law, royalty income generally is excluded from UBTI. The House Bill does not include a proposal on this point.

The Senate Markup also includes a provision requiring the computation of UBTI separately for each separate unrelated trade or business, which (depending on the particular facts) could limit the use of certain unrelated trade or business losses to offset income from name or logo licensing or profitable unrelated trades or businesses.

Repeal of tax-exempt status for professional sports leagues

The Senate Markup proposes to eliminate the tax exemption for professional sports leagues, regardless of size. Since 1966, U.S. tax law has exempted professional football leagues from tax, and the Internal Revenue Service has historically interpreted this exemption to apply to all professional sports leagues. The House Bill does not include a corresponding proposal.

No tax-exempt bonds for professional stadiums

The House Bill proposes the imposition of tax on interest on bonds issued to finance the construction of, or capital expenditures for, a professional sports stadium (defined as any facility that is used as a stadium or arena for professional sports exhibitions, games or training for at least five days in any calendar year). The provision would be effective for bonds issued after November 2, 2017. The Senate Markup does not include such a proposal.

No deduction for amounts paid in exchange for college athletic seating rights

The Senate Markup and the House Bill both propose that no charitable deduction be allowed for any payment made to an institution of higher education in exchange for the right to purchase tickets or seating for athletic events. These proposals effectively repeal the existing special rule that allows the purchaser to take a charitable deduction of 80% of the amount paid for the right to purchase the tickets.

Provisions in House Bill but not in Senate Markup

Among the provisions that were included in the House Bill but are not included in the Senate Markup are: the elimination of the Johnson Amendment prohibiting political activity by Section 501(c)(3) organizations; the elimination of new tax-exempt private activity bonds (although the Senate Markup would eliminate advance refundings); the elimination of the qualified tuition reduction; and certain modifications to the unrelated business income tax.

[1] Tax Cuts and Jobs Act, H.R. 1, as reported by the House Committee on Ways & Means to the House Rules Committee, Nov. 10, 2017.

[2] Joint Committee on Taxation, Description of the Chairman's Mark of the "Tax Cuts and Jobs Act" as reported by the Senate Finance Committee, Nov. 9, 2017.

[3] Amendment to the Amendment in the Nature of a Substitute to H.R. 1, the "Tax Cuts and Jobs Act," Nov. 9, 2017.

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