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UPDATED: The Effect of the Tax Cuts and Jobs Act on Tax-Exempt Associations

On December 15, 2017, the House of Representatives published the Conference Report resolving the differences between the versions of the "Tax Cuts and Jobs Act" passed by the House (the "House Bill") and by the Senate (the "Senate Bill"). The Conference Report represents the final version of the "Tax Cuts and Jobs Act" (the "Tax Act") passed by both the House and Senate.

The Tax Act includes several provisions that may significantly impact tax-exempt associations, though the final version is much less impactful than the earlier versions of the legislation. However, as the Tax Act includes several provisions relating to unrelated business income ("UBI") and executive compensation, the Tax Act is, none-the-less, likely to increase the amount of association income subject to tax.

Here is a brief description of the provisions of the Tax Act which are likely to have the most significant impact on tax-exempt associations.

<u>Proposed Changes Related to UBI</u>

The Tax Act includes several specific changes which will increase the amount of association income that may be subject to tax as UBI. However, the effect of the increase in the amount of taxable income may be partially offset by the Tax Act's reduction in the corporate tax rate.

The proposed changes related to UBI include: (1) the calculation of UBI and application of NOL carryovers; (2) the increase of UBI by the amount of certain fringe benefit expenses; and (3) a reduction in the overall corporate tax rate applicable to taxable UBI.

Provisions of prior versions of the legislation that are <u>not</u> included in the final, reconciled version of the Tax Act, include: (1) the proposed Senate provision taxing all royalties received from the licensing of an organization's name and/or logo; (2) the House's provision clarifying that UBI is taxable for tax-exempt organizations whose income is excluded from the definition of gross income pursuant to §115(1) of the Internal Revenue Code ("Code"); and (3) the House Bill's provision limiting the UBI exclusion for fundamental research.

1) Revisions Affecting the Calculation of Taxable UBI

The Tax Act's most significant proposed change to UBI, potentially impacting all exempt organizations engaged in any unrelated business activity, is the addition of subsection (6) to Code § 512(a) which provides that the amount of taxable UBI must be computed by adding the sum of the taxable income derived from each unrelated business activity. For example, an organization which engages in two unrelated business activities, one of which produces a net loss and one of which produces a net gain, will not be able to reduce the amount of tax paid on the profitable business activity by the losses incurred from its unprofitable business activity. Rather, the organization will be required to pay tax on its profitable unrelated business activity and then carry over the net losses from its unprofitable activity as an NOL which may only be used to reduce the potential tax on future income derived from that same business activity.

The obvious effect of this provision is that it may substantially increase association taxes because organizations will no longer be permitted to offset the taxable gains from profitable business activities with the losses from unprofitable unrelated business activities. The less obvious, but also significant, impact of this provision relates to the complexity of keeping records demonstrating the profits or loss of each unrelated business activity. For instance, not only will an organization be required to track general items of income and expense as being attributable to a related or unrelated business, but organizations will need to apportion all overhead expenses, including, rent, employee time, general resources, etc…, to each specific unrelated activity.

Additionally, since the Code does not clearly define the concept of "each trade or business" there is likely to be significant confusion as to how organizations should calculate and apportion income to their various unrelated activities. For example, if an organization has a publication for which it receives UBI from the sale of advertising and the organization holds events—which are entirely independent of producing its publication—for which it also sells advertising, is the organization engaged in a single unrelated activity—the sale of advertising—to which all relevant expense deductions may be applied? Or is the organization engaged in two or more unrelated activities—the sale of advertising in relation to the production of a publication and the sale of advertising in relation to particular events—for which the organization must separately calculate the amount of UBI received? This process would be further complicated by the fact that advertisers may receive discounts for advertising in both the organization's publication and at the organization's other event programs which would need to be apportioned across all unrelated advertising activities.

Finally, to the extent that an organization has losses from some activities and gains from others, the organization will need to track and apply NOLs according to multiple schedules based both on timing and on the nature of the activity. As such, this provision of the Tax Act represents a potentially significant increase in organization expenses both due to the obvious increase in tax liability but also due to the less obvious additional time and effort necessary to properly determine and document the amount of tax liability.

2) Revisions Increasing UBI by the Amount of Certain Fringe Benefits

The Tax Act also increases the amount of taxable UBI by characterizing certain expenses as taxable UBI. The Tax Act adds a new subsection (7) to Code § 512(a) providing that an organization's UBI shall be increased by nondeductible portion of any amount paid for qualified transportation fringe benefits, any parking facility used in connection with qualified parking, and on-premises athletic facilities.

3) Revisions Affecting the Tax Rate Applicable to Taxable UBI

Though not directly related to the tax on UBI, the change to the corporate tax rate provided in the Tax Act may benefit tax-exempt organizations subject to tax on their unrelated business income. The Tax Act eliminates the graduated corporate income tax rates in favor of a single corporate tax rate of 21%. As such, all organizations currently paying a blended tax rate in excess of 21% will reap the benefits of a reduced tax rate which may mitigate the expense of the additional amounts of income which may be subject to tax under this legislation.

Proposed Changes Related to Executive Compensation

In addition to changing the law related to UBI, the Tax Act also potentially increases association taxes by creating a new Code § 4960 which imposes an excise tax on executive compensation. While this will increase the taxes of certain associations, the final version of the Tax Act is better for associations than prior versions because it eliminates the provision which would have extended the draconian penalties of Code § 4958 to organization's exempt under sections 501(c)(5) and 501(c)(6).

1) Excise Tax on the Amount of Executive Compensation Paid in Excess of $1 Million

The Tax Act creates new Code § 4960 which imposes an excise tax on exempt organizations equal to 21% of the total remuneration paid to each covered employee which exceeds $1 million plus certain excessive parachute payments. For purposes of determining the amount of remuneration paid to a covered employee, section 4960(c)(4) looks to the total remuneration provided by the organization and all related individuals and entities. For purposes of this provision, "covered employees" includes any employee (including former employees) who is among the organization's five highest paid employees for the taxable year or who was a covered employee for any preceding tax year.

Other Potentially Impactful Legislative Changes

In addition, to the changes related to UBI and executive compensation, questions have arisen as to whether the Tax Act's revision of Code § 274 limits deductions by employers for fringe benefit expenses.

Specific issues have arisen as to whether the Tax Act will impact the ability of association members to deduct the cost of membership dues.

This issue relates to the language in the House Bill which proposed amending Code § 274 to specifically provide that membership dues will not be deductible when paid for "membership in any club organized for business, pleasure, recreation, or other social purposes." This is potentially a significant issue for tax-exempt associations whose members historically have been entitled to deduct the cost of membership dues. However, this issue has become somewhat moot as the final version of the Tax Act does not incorporate the House Bill provision and, instead, follows a similar provision in the Senate Bill. The most notable difference between the House and Senate Bills being that the Senate Bill did not include language that specifically denies deductions for expenses related to club membership.

In addition to eliminating the language specifically denying deductions for certain membership dues, the final version of the Tax Act is focused on denying expenses related to amusement and recreation. Such focus indicates that this provision should only be applicable to dues paid for membership in social clubs exempt under Code § 501(c)(7), not associations exempt under section 501(c)(6). Pursuant to the Code and the underlying regulations, to be exempt under section 501(c)(7), an organization must be organized and operated for the recreation and pleasure of its members. These are requirements consistent with the language used in the Tax Act. However, unlike clubs exempt under section 501(c)(7), associations exempt under section 501(c)(6) are not to be organized or operated for the pleasure and recreation of the club's members. Rather, pursuant to the regulations, to be exempt under section 501(c)(6) an organization must be "an association of persons having some common business interest" the activities of which must be "directed toward the improvement of the business conditions for one or more lines of business." As such, we do not believe that the Tax Act's changes to section 274 should impact the deductibility of dues paid for membership in an association exempt under section 501(c)(6).

<u>Contacts</u>

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