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Nonprofits and Exempt Organizations One Year After Tax Reform

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Nonprofits and Exempt Organizations One Year After Tax Reform

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J. Marc Fosse, Director
Trucker Huss, San Francisco
mfosse@truckerhuss.com

Michele A. W. McKinnon, Partner
McGuireWoods, Richmond, Va.
mmckinnon@mcguirewoods.com

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Nonprofits and Exempt Organizations after Tax Reform

J. Marc Fosse, Esq.

February 13, 2019

Introduction

- Changes Affecting the Unrelated Business Income Tax
- Tax Penalty on Excess Compensation Paid by Tax-Exempt Organizations
- Effects of 2017 Tax Act on Charitable Giving
- Miscellaneous Tax Changes Affecting Tax-Exempt Organizations
- Other Charitable Giving and Exempt Organization Developments

2017 Tax Act Changes Affecting the Unrelated Business Income Tax and Recent Developments

UBIT: Effect of New Corporate Income Tax Rate

- Change in corporate income tax rate to a flat 21% impacts the UBIT of exempt organizations that are corporations
  - Organizations previously paying an effective rate greater than 21% (with taxable income of approximately $90,500 or more) should have lower overall UBIT liability
  - Organizations paying an effective rate less than 21% will pay a higher tax on that UBTI with the flat rate and loss of the 15% bracket under prior law
  - UBIT rate for trusts goes to 37% (with significant compression of the brackets)
- Corporate tax rate also applies in other areas (mostly for 501(c)(4), (c)(5), and (c)(6) organizations
  - Tax on political expenditures under IRC section 527(b)
  - Proxy tax on lobbying expenditures under IRC section 6033(e)

UBIT: New "Silo" Rules

- UBTI must now be determined separately for each unrelated trade or business for tax years beginning after 2017 so that losses from one activity may not offset income from another activity
- No guidance or criteria in statutory provisions regarding how to determine what is a separate trade or business
- These silo rules may make taxable subsidiaries more attractive
- Major concern following enactment was impact on UBTI derived from investment activities

IRS Notice 2018-67

- This notice provides guidance on issues related to UBTI under the 2017 Tax Act (new IRC section 512(a)(6)
  - Contains concepts for identifying separate trades or businesses under the silo rules
  - Permits interim reliance on a reasonable, good faith standard for determining separate trades or businesses
  - Contains rules regarding partnership income, including interim and transition rules for aggregating income from partnerships and debt-financed income from partnerships
  - Contains information on how to calculate net operating losses within the framework of IRC section 512(a)(6)
  - Clarifies that an inclusion of GILTI is treated as a dividend for UBIT purposes

IRS Notice 2018-67 (continued)

- Interim and transition rules (but not for 501(c)(7) organizations)
  - Reasonable, good faith interpretation of UBTI rules for determining “one or more” trades or businesses
  - Aggregation of “qualified partnership interests” is permitted if held for investment purposes and meet de minimis test (less than 2%) or control test (less than 20% and no control or influence over partnership)
  - Other non-qualified partnership interests can each be treated as a separate trade or business
  - IRC section 512(a)(7) expenses are not an unrelated trade or business

UBIT: Net Operating Losses

- NOLs may still be carried forward to offset UBTI in a later year, but may only be applied against the net income the trade or business that resulted in the prior year NOL
  - NOLs from a tax year beginning before 2018 are excluded from this limitation and can offset all UBTI
- NOLs incurred after 2017 may no longer be carried back
- A carryforward of any NOL incurred after 2017 may only be used against 80% of taxable income, but the 20-year limit on the use of NOL carryforwards is eliminated
- No guidance on how NOLs are treated if trade or business is sold, stopped, or restarted
- IRS Notice 2018-67 specifically requested comments on calculation and ordering of pre-2018 NOLs and treatment of expiring NOLs

TAX PENALTIES ON EXCESS COMPENSATION PAID BY TAX-EXEMPT ORGANIZATIONS

New Section 4960 Tax Penalties on Excess Compensation

- Penalty under section 4690 of the Internal Revenue Code (the "Code") —
  - "Applicable tax-exempt organization" ("ATEO") pays the excise tax penalty
  - Tied to corporate tax rate, which is currently 21%
  - Applies to remuneration paid to "covered employees" for a taxable year:
    - In excess of $1,000,000, or
    - Which are "excess parachute payments"
  - ***Does not change the covered employee's tax treatment for the compensation***

Applicable Tax-Exempt Organization

- Any organization that is exempt from taxation under:
  - Code section 501(a)
    - Covers all entities exempt from tax under 501(b) and (c), including 501(c)(3) organizations
  - Code section 115(1)
    - This covers all entities that exercise essential governmental functions and its income accrues to the state
    - Does not cover actual state government or its political subdivisions
  - Code section 521(b)(1) farmers cooperative org
  - Code section 527(e)(1) political organization

Applicable Tax-Exempt Organization

- Notice 2019-09 – If employer does not have any "highly compensated employees" for a taxable year, then not subject to the 4960 excise taxes
  - For example, an employer that does not pay compensation (within the meaning of section 414(q)) of $125,000 to any employee in 2018 and 2019 is not subject to the excise tax

Applicable Tax-Exempt Organization

- Notice 2019-09, Q&A-5 – A governmental entity (including a college or university) that is not tax exempt under section 501(a) and does not exclude income under section 115(1) is not an ATEO
- Notice 2019, Q&A-6 – A government agency that sought and received a determination letter recognizing its tax exempt status under section 501(c)(3), may relinquish that status
  - Rev. Proc. 2018-5
  - If exclude income from tax under section 115(1), then still an ATEO

Applicable Tax-Exempt Organizations

- Which governmental entities are not subject to 4960 excise tax?
- A state political subdivision is generally an entity to delegated significant authority to use one or more of the state's police powers -- taxing power, police power and eminent domain
  - States and their public subdivisions are exempt from federal income tax based on the Constitutional doctrine of intergovernmental immunity
  - E.g., municipal corporations such as counties, cities or townships

Applicable Tax-Exempt Organizations

- A Code section 115 quasi-governmental organization is an entity whose income is exempt from federal taxation because its income is "derived from the exercise of any essential governmental function and accruing to a State or any of its political subdivisions."
- Because 501(c)(3), 115 quasi-governmental agencies and political subdivisions are all exempt from federal income tax, it previously was not very significant to the IRS which designation the college or university received

Applicable Tax-Exempt Organizations

- There are a couple of significant reasons that state schools seek a 501(c)(3) designation:
  - 501(c)(3) organizations enjoy higher deduction limits for donations
  - It is generally easier for foundations to make donations directly to 501(c)(3) organizations

Related Organizations

- A <u>person</u> or <u>governmental entity</u> related to an applicable tax-exempt organization during a taxable year which—
  - controls, or is controlled by, the organization;
  - is controlled by one or more persons which control the organization;
  - is a supported organization (as defined in section 509(f)(3));
  - is a supporting organization described in section 509(a)(3); or
  - Certain VEBAs

Related Organizations

- Notice 2019-09, Q&A-8 adopts a "control" test from section 512(b)(13)(D)
- Rejected controlled group tests under section 414 "single" employer concept with uses an 80% threshold

Related Organizations

- Example 1. A, B, and C are nonstock organizations and are ATEOs within the meaning of section 4960(c)(1). C owns 80 percent of the stock of corporation D. Eighty percent of B’s directors are representatives of A. In addition, 80 percent of C’s directors are representatives of A. A is a related organization with respect to B (and vice versa) because more than 50 percent of B’s directors are representatives of A; thus, A controls B. Based on the same analysis, A is also a related organization with respect to C (and vice versa). D is a related organization with respect to C because, as the owner of more than 50 percent of D’s stock, C controls D. Applying the principles of section 318, A is deemed to own 64 percent of the stock of D (80 percent of C’s stock in D). Thus, D is a related organization with respect to A because A controls D. B is a related organization with respect to C, C is a related organization with respect to B, and D is a related organization with respect to B because B, C, and D are all controlled by the same person (A).

Related Organizations

- Example 2. X, Y, and Z are nonstock organizations and are ATEOs within the meaning of section 4960(c)(1). Sixty percent of Y's directors are representatives of X. In addition, 60 percent of Z's directors are representatives of Y. X is a related organization with respect to Y (and vice versa) because more than 50 percent of Y's directors are representatives of X; thus, X controls Y. Based on the same analysis, Z is a related organization with respect to Y (and vice versa). Applying the principles of section 318, X is deemed to control 36 percent of Z's directors (60 percent of Y's 60 percent control over Z). Because less than 50 percent of Z's directors are representatives of or controlled by X, and absent any facts suggesting that X directly or indirectly controls Z, X is not a related organization with respect to Z.

Multiple Payors of Excess Compensation

- All remuneration from related organizations included in calculating the penalty
- If remuneration from more than one "employer" is taken into account in calculating the penalty --
  - Then each employer pays pro-rata share of penalty
    - It does not say that each related organization pays a pro-rata share of the excise tax
    - Excise tax is paid at employer level
    - Employer is the common law employer
      - Payment from a third-party payor (payroll agent, paymaster, PEO or statutory employer) treated as payment from employer

Covered Employee

- Five highest paid employees of the organization
  - Not necessarily top five on Form 990 because 990 reports income that is not 3401(a) wages
  - Not wages on covered employee's Form W-2
  - Must look at 3401(a) wages
- Once a covered employee, always of covered employee
  - Beginning in taxable year that begins after December 31, 2016
  - For compensation from that tax-exempt organization

Taxable Year

- Notice 2019-09: the taxable year is the calendar year ending with or within the taxable year of the employer
- Aligns with W-2 reporting
- May be easier to calculate section 3401(a) taxable wages
- Single standard for determining covered employees and computing excise tax

Group of ATEOs

- IRS rejected commenters suggestions that only one ATEO in a controlled group of ATEOs need to identify covered employees
- IRS stated that all ATEOs must identify covered employees
- How many CEOs in your organization?

Remuneration

- Code Section 3401 wages (basically W-2 wages)
  - Benefits from tax-qualified plans are excluded
  - Non-taxable fringe benefits excluded
  - Roth contributions are excluded
  - Certain director fees (Q&A—12)
- Treated as paid when no longer subject to a substantial risk of forfeiture (i.e., vested)
- Excludes any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional (See Q&A-15)
- $1,000,000 threshold not adjust for inflation

Remuneration

- IRS rejected any grandfathering rule
- Notice 2019-09 states that any vested amount (including vested but unpaid earnings on deferred amounts) that was treated as paid prior to January 1, 2018, is not subject to the excise tax
- Helpful for 457(f) plans with a 409A tail
  - If elected a deferred payment in accordance with section 409A
  - Then amounts that vested prior to January 1, 2018 (and related vested earnings) not included

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Welcome to the World of Excess Parachute Payments

- "Parachute payment" means any payment in the nature of compensation to (or for the benefit of) a covered employee if:
- The payment is contingent on the covered employee's separation from employment with the employer, and
- The parachute payment is equal to or in excess of 3x the employee's "base amount"
  - Unlike Code section 280G --
    - No change of control needed
    - No reasonable compensation exception
- Separation from employment must be involuntary (Q&A-20) or pursuant to a window program (Q&A-21)
- Amounts subject to accelerated vesting on involuntary termination of employment are included to the extend of the additional value (Q&A-24)

Base Amount

- Base amount is the same as under Code section 280G(b)(3)—
  - Annualized includible compensation for base period.
  - In other words, the covered employee's average annual compensation for the past five years with the applicable tax-exempt organization (or if less than five years, the lesser period

Exceptions

- The following payments will not be treated as parachute payments—
  - Payments from tax-qualified plans;
  - Benefits paid from a 403(b) or 457(b) plan;
  - Payments for medical or veterinary services by such professional; or
  - Payments to a non-highly-compensated employee (Code section 414(q))

Excess Parachute Payments

- The penalty is calculated based on the amount by which the excess parachute payment exceeds the base amount
- Summary: If the covered employee is paid severance (based on involuntary termination of employment) in excess of three times her or his average compensation for the past five years, then the amount paid in excess of that average compensation is subject to a 21% penalty, payable by the applicable tax-exempt organization

New Section 4960 Tax Penalties on Excess Compensation

- **Methods of Minimizing or Reducing Excess Compensation Penalties**
  - Maximize Excluded Tax-Qualified Retirement Benefits
    - Defined benefit plans
    - Defined contribution plans
      - profit sharing contributions
      - Roth *contributions*
    - QSERP
    - 403(b) — Mandatory Deferrals and Employer Contributions
    - 457(b) Plan

New Section 4960 Tax Penalties on Excess Compensation

> 457(f) Deferred income inclusion until vested (Substantial risk of forfeiture)
  - Defer income to retirement
  - Include Non-Compete Post-Termination/Retirement Deferral Period
    - Stagger payments over five years with non-compete
  - May require modeling
  - Can use rolling vesting to extend pre-retirement vesting period
    - Requires modeling

New Plan Designs for 457(f) Plans Can Help Recruiting and Retention

- **Non-Compete As A Substantial Risk of Forfeiture/Post-Termination Deferrals**
  - The proposed regulations provide that a post-termination non-compete provision can create a post-termination of employment substantial risk of forfeiture
  - Hospitals have an interest in their executive not competing with the hospital for talent and fundraising
    - Retirements for non-compete vesting period
  - Preempts California restrictions on non-competes because it is an ERISA plan

New Plan Designs for 457(f) Plans Can Help Recruiting and Retention

✦ Rolling Vesting

> Requirements

- Enter into written agreement 90 days before current vesting period
- Extend vesting for minimum of two years
- Employer must increase account balance subject to extended vesting by no less than 25.01%

New Plan Designs for 457(f) Plans Can Help Recruiting and Retention

- Vesting Extensions
  - 90 days before vesting date enter into new written agreement
  - Extends for minimum 2 years
  - Employer contributes material amount (+25%)
- Non-compete post-termination vesting periods
- Addition of Short-Term Deferral Rules to 457(f) regulations

Effects of 2017 Tax Act on Charitable Giving

Overview

- Only a few direct changes to the income tax charitable deduction provisions of IRC section 170
- But other changes to the individual income tax, as well as the estate and gift tax, are expected to impact charitable giving
- Overall, and except for college sports supporters/fans, the income tax charitable deduction was not changed significantly
- Concern over past proposals did not materialize and the complexities of section 170 still exist
    - Section 170 is long and complicated
    - Section 170 is the most litigated section of the IRC according to a report issued by the National Taxpayer Advocate

Income Tax Charitable Deduction Rules before the 2017 Tax Act

- Donors must itemize deductions
- Overall limit on itemized deductions – the “Pease Amendment”
- 50% limit on cash gifts to 50%-type organizations
- 30% limit on appreciated property gifts to 50%-type organizations
- 30% limit on cash gifts to private foundations
- Special rules for gifts of appreciated property to private foundations
- Five-year carryover for amounts that cannot be deducted because of percentage limitations
- Special rules for contributions or tangible personal property and ordinary income property

2017 Tax Act Changes Affecting the Income Tax Charitable Deduction

- Annual limit on cash contributions to public charities increased from 50% to 60%...maybe
  - Because of reduction provisions in the new law, other types of gifts (of property or to private foundations) appear to impact the percentage limitations
  - This change is effective after 2017 and before 2026
- Deduction for amounts paid in exchange for college athletic seating rights is repealed for contributions after 2017
  - This change permanently repeals the "80/20 rule"
  - Expected to raise $2 billion over 10 years

Other Changes to the Charitable Deduction Rules

- The exception to the contemporaneous written acknowledgement rules that applied if the donee reported the contributions is repealed for tax years after 2016
- The charitable deduction available to an electing small business trust ("ESBT"), which is a permissible S corporation shareholder, is now determined under the rules that apply to individuals instead of the trust charitable deduction provisions of IRC section 642(c)
  - This could provide benefits as it eliminates governing instrument and gross income requirements of section 642(c) and should permit a deduction for property gifts, but percentage limitations and substantiation rules should apply
  - This provision is effective for tax years after 2018 and is permanent

Other 2017 Tax Act Changes Anticipated to Affect Charitable Giving

- Modification of Income Tax Rates
  - Top rate for single taxpayers making more than $510,300 and married taxpayers making more than $612,350 in 2019 is 37%
- Pease Amendment that affected certain higher income taxpayers is suspended until 2026
  - Reduced itemized deductions if income over a certain amount by an amount equal to lesser of 3% or 80% of itemized deductions
- Standard deduction doubled and personal exemption eliminated
- Other itemized deductions repealed
- Estate and gift tax exclusion amount and GST exemption doubled to $11.4 million for 2019 after adjustment for inflation
- These changes apply through 2025

Impact of Income and Transfer Tax Changes on Charitable Giving

- Concern is that these changes will have a significant impact on charitable giving
- Lower income tax rates may not be significant enough to affect a taxpayer's giving
- Increase in standard deduction and loss of or reduction in a number of itemized deductions is expected to reduce itemizers from about 30% of taxpayers to 5% of taxpayers (estimated impact of as much as $24 billion)
- Repeal of Pease Amendment is good for itemizers
- Unclear what impact of doubled estate and gift tax exclusion amount will be, although charitable giving declined in 2010 when estate tax was repealed

General Observations on Charitable Giving Impact

- For charitably-inclined, high net worth taxpayers, changes in tax laws are unlikely to affect charitable giving as the tax laws continue to provide substantial benefits to these taxpayers
- Taxpayers may prefer lifetime gifts to obtain income tax benefits if not likely to be subject to estate tax
- At death, gifts of retirement assets are particularly attractive for taxpayers not subject to the estate tax
- For non-itemizers over age 70½, qualified distributions from an IRA may be more attractive, but need to compare benefits of gift of appreciated property
- Gifts of appreciated property continue to offer tax benefits
- Some taxpayers who do not ordinarily itemize may want to bunch gifts and may want to consider gifts to donor advised funds and private foundations
  - Must have resources to do this
  - Need to consider impact on charitable donees also

Findings from 2016 U.S. Trust Study of High Net Worth Philanthropy – Executive Summary

- 28% of high net worth individuals plan to increase charitable giving in the next three years
- 33% of high net worth individuals participate in impact investing and 34% of them do it in place of some of their charitable giving, while 5% do it in place of all charitable giving
- Receiving tax benefits only motivated 18% of wealthy donors in 2015 as compared to 34% of donors in 2013
- Personal and altruistic reasons for giving:
  - Belief in mission (54%)
  - Belief that gift can make a difference (44%)
  - Personal satisfaction, enjoyment, or fulfillment (39%)
- Greatest challenge is identifying causes they care about and where to donate (67%)

Study available at www.ustrust.com/publish/content/application/pdf/GWMOL/USTp_ARMCGDN7_oct_2017.pdf

Findings from 2018 U.S. Trust Study of High Net Worth Philanthropy

- Percentage of giving by HNW women and African-Americans is higher than percentage of giving by all HNW individuals
- 28% of HNW individuals plan to increase giving in next 3 years
- Millennials and women are more likely to participate in impact investing
- More women volunteer than men
- Receiving tax benefits only motivated 17% of HNW donors in 2017
- Only 42% believe their giving is having intended impact

Study available at https://www.ustrust.com/articles/2018-us-trust-study-of-high-net-worth-philanthropy.html

MISCELLANEOUS TAX CHANGES AFFECTING TAX-EXEMPT ORGANIZATIONS

Tickets to College Athletic Events:

- The "Tax Cuts and Jobs Act" (the "Act") repeals the current law that allows a donor who makes a contribution to a tax-exempt college or university, for the purpose of obtaining priority seating at athletic events, to take a charitable contribution deduction of 80 percent of the amount donated.

Excise Tax on Endowments of Nonprofit Colleges & Universities

- The law includes a new excise tax of 1.4 percent on the net investment incomes of "applicable educational institutions," meaning nonprofit colleges and universities that:
  - Had at least 500 tuition-paying students in preceding taxable year
  - The aggregate FMV of the assets (not used directly in carrying out the institution's exempt purpose) is at least $500,000 per student of the institution; and
  - More than 50 percent of the tuition-paying students are located in the United States.

Certain Fringe Benefits Subject to UBIT

- Tax-exempt organizations will generate UBIT on the value of providing the following fringe benefits tax-free:
  - Payment of qualified transportation fringe benefits
  - Costs associated with any parking facility used to provide employee parking
  - Costs associated with any on-premises athletic facility
- Providing taxable benefits is not subject to UBIT
- Permitting employees to pay pre-tax for qualified transportation and parking is subject to UBIT

Repeals Tax-Exempt Treatment for Interest on Income from Advanced Refunding Bonds

- Nonprofits often use advance refunding bonds to help reduce the cost of borrowing to finance projects like construction or other capital investments.
- The Act repeals the exclusion from gross income for interest on a bond issued to advance refund another bond. Interest paid to advance refunding bond investors is now taxable.

Other Charitable Giving and Exempt Organization Developments

Charitable Deduction Developments

- IRS released new regulations regarding the substantiation and reporting requirements for cash and noncash contributions following the enactment of provisions in the American Jobs Creation Act of 2004 and the Pension Protection Act of 2006 (T.D. 9836)
  - The regulations are effective as of July 30, 2018
  - The regulations clarify that a blank pledge card provided to a donor is not sufficient substantiation for a cash contribution
  - Any substantiation requirements for submission of information with the tax return also apply to the returns for any year in which a carryover of that deduction is claimed
  - The regulations address the requirements for completing Form 8283 as well as the new requirements for a "qualified appraiser" and a "qualified appraisal"

Charitable Deduction Developments (continued)

- Representative Smith (R-NJ) has recently introduced a bill to allow charitable contributions as an above-the-line deduction
- Charitable Giving Tax Deduction Act introduced in House on May 10, 2018 would allow charitable contributions as an above-the-line deduction
- Senator Thune (R-SD) has introduced the Death Tax Repeal Act of 2019, which would repeal the federal estate tax

Charitable Deduction Developments in the States

- Legislators in several states have introduced bills to permit taxpayers to claim state charitable deductions even when using the standard deduction on their federal returns – Kansas, New York, Virginia
- Some states permit the charitable deduction for non-itemizers (Colorado and Minnesota) or have proposals to do so (Arizona)
- IRS issued proposed regulations in August 2018 to address state attempts to circumvent new limits on deductibility of state and local taxes
  - Received significant attention because they ensnare longstanding state tax credit programs that support education, conservation, poverty relief, and other initiatives
  - Apply to contributions made by individuals, trusts, and decedents' estates after August 27, 2018
  - Disallows a charitable deduction to the extent donor receives state tax credits in return if credits exceed 15% of the contribution

Reducing Excessive Debt and Unfair Cost of Education (REDUCE) Act

- While focused on endowments and spending, this Act contains several significant provisions related to charitable contributions to colleges and universities
  - Would eliminate the charitable deduction for any restricted gift to a college or university of more than $5,000 unless it is used for scholarships
  - For unrestricted gifts or gifts for scholarships for working family students, the bill allow additional deductions in excess of the percentage limitations set forth in IRC section 170.
  - Would disallow a charitable deduction for gifts to the college or university if it has a period in which there is an undistributed required payout
  - Any restricted distribution from a DAF or private foundation would be a taxable distribution or taxable expenditure and subject to 100% excise tax

Miscellaneous EO Developments

- Rev. Proc. 2018-15: IRS announced that it generally will not require a new exemption application from a domestic section 501(c) organization in connection with certain corporate restructurings
- Rev. Proc. 2018-38: Donor information, such as names and addresses, is no longer required to be reported on Schedule B of Form 990 for certain exempt organizations, except "when needed for tax administration"
  - The changes apply to those exempt under 501(a), other than 501(c)(3) organizations, that are required to file a Form 990 or 990-EZ
  - The organizations must continue to collect and keep this information in their books and records and to make it available to the IRS upon request
  - Spotlight Act introduced in July 2018 would reinstate the disclosure requirements
- Good Incentives for Vital Non-Profit Governance (GIVING) Act would create a new status for 501(c)(3) organizations with administrative expenses not exceeding 25% of contributions

Miscellaneous EO Developments (continued)

- Nonprofits Support Act introduced in June 2018 to repeal IRC sections 512(a)(6) and (7)
- LIFT for Charities ACT introduced in July 2018 to repeal IRC section 512(a)(7)
- Stop the Tax Hike on Charities and Places of Worship Act introduced in July 2018 to repeal IRC section 512(a)(7) and increase the corporate tax rate to 22%

Questions or Comments?

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