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BLOG POST

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Tax Proposal Impacts on Tax-Exempt Organizations

The U.S. House Ways & Means Committee has released a tax package proposal that includes a number of provisions that would significantly affect charities, especially private foundations, as well as their donors. While it is difficult to predict the legs of any of the proposals, as we are early in the budget reconciliation process, we think it is important to be aware of the current proposals that are most salient to charitable and other nonprofit organizations.

1. Increased Private Foundation Net Investment Income Tax

IRC Section 4940 imposes a 1.39% tax on the net investment income of private foundations. The proposed amendment increases the tax for private foundations with aggregate assets of $50,000,000 or more, as determined at the close of each taxable year. Taxes increase as assets increase, as follows:

Assets	Tax on Net Investment Income
Less than $50M	1.39%
$50M – Less than $250M	2.78%
$250M – Less than $5B	5%
$5B or more	10%

Assets of a private foundation would be aggregated with related organizations to determine the applicable tax rate. The proposal says that a "related organization" is one that "controls, or is controlled by, such private foundation" or "is controlled by 1 or more persons which also control such private foundation." The proposal does not include a definition of "control," nor does it limit the scope of related organizations to tax-exempt organizations.

If approved as drafted, the increased taxes would apply to taxable years beginning after the enactment of the bill. Assuming the final bill is enacted in the fall of 2025, many private foundations with calendar year tax years will have little time to interpret and plan for this increase.

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ABOUT OUR BLOG

Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

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2. **Increased Colleges and Universities Investment Income Tax**

Similar to the private foundation net investment income tax, IRC Section 4968 imposes a 1.4% tax on the net investment income of certain private educational institutions. Also like private foundations, the proposal increases the tax for institutions with a "student-adjusted endowment" (investment assets per eligible enrolled students) of $750,000 or more. Taxes increase as the student-adjusted endowment figure increases, as follows:

Student-Adjusted Endowment	Tax on Net Investment Income
$500,000 – $749,999	1.39%
$750,000 – $1,249,999	7%
$1,250,000 – $1,999,999	14%
$2,000,000 or more	21%

The proposal removes certain non-U.S. students from the calculation of student-adjusted endowment, and changes the definition of net investment income to include student loan interest and royalties. Both of these proposals will make the student-adjusted endowment and taxable amounts higher for many institutions. It also exempts religious organizations.

3. **Expansion of Excess Compensation & Parachute Payment Tax**

IRC Section 4960 imposes a tax on excess compensation or parachute payments of more than $1,000,000 paid by an applicable tax-exempt organization and its related organizations to its "covered employees". The proposed amendment to Section 4960 greatly expands the definition of "covered employees" from current or former 5 highest compensated employees (listed on the Form 990) to all current and former employees of the organization, "or any related person or governmental entity." This change would apply to taxable years beginning after December 31, 2025.

This tax was first imposed in the Tax Cuts and Jobs Act of 2017 (TCJA), and while the law may have been intended to apply primarily to highly compensated college and university sports coaches, the law did not actually capture some public universities as applicable tax-exempt organizations. The proposed amendment appears, at least in part, to be an attempt to fix that oversight from 2017 by including employees of "any related person or governmental entity," but it is unclear if that would be sufficient without additional statutory or regulatory guidance.

4. **Limited Exception to Excess Business Holdings for Certain Employee Stock Repurchases**

Under Section 4943, private foundations are subject to an excise tax on their excess business holdings if they and their disqualified persons together hold more than 20% of the voting stock of a corporation. Under current law, if a corporation buys back a portion of its voting stock (thus increasing the remaining shareholders' relative percentages of voting stock), this could result in the private foundation having an excess business holding even when the foundation has not acquired additional stock. Under the proposal, certain repurchases of voting stock by the corporation from an employee stock ownership plan would continue to be treated as outstanding voting stock and would not result in the private foundation having an excess business holding.

5. **Charitable Deduction for Non-Itemizing Individuals and Corporations**

Currently, individuals who do not itemize deductions on their annual returns are not entitled to a deduction under Section 170 for contributions to charitable organizations. Under the proposal, individuals who do not itemize their deductions would be eligible for a charitable deduction of up to $150 ($300 in the case of joint returns), to the extent of any cash contributions to charitable organizations, except that cash contributions to supporting organizations described in Section 509(a)(3) and cash contributions for the establishment or maintenance of a donor advised fund would not be eligible for the charitable deduction.

Under current law, corporations are subject to a charitable deduction limitation of 10% of their taxable income. The proposal would additionally add a 1% floor to the corporate charitable deduction, such that a corporation would only be allowed a deduction for the amount of charitable contributions that exceeds 1% of the corporation's taxable income, though still subject to the 10% ceiling. The proposal would allow charitable contributions in excess of the 10% ceiling to be carried forward for up to 5 years.

6. **Increases to UBTI**

Certain Transportation Fringe Expenses. In 2017, as part of the TCJA, Section 274 was modified to disallow most qualified parking (defined in Section 132(f)(5)(C)) and qualified transportation fringe (defined in Section 132(f)(1)) deductions allowable to employers who provide such benefits to their employees. Also as part of the TCJA, Section 512(a)(7) was added to increase a tax-exempt organization's unrelated business taxable income by amounts that the organization paid or incurred for any qualified transportation fringe, any parking facility used in connection with qualified parking, or any on-premises athletic facility that were not deductible under Section 274. Section 512(a)(7) was repealed retroactively under the Tax Certainty and Disaster Relief Act of 2019.

The proposal would reinstate Section 512(a)(7) with respect to amounts paid or incurred for any qualified transportation fringe or any parking facility used in connection with qualified parking that are not deductible under Section 274. Under the proposal, churches and certain church-affiliated organizations would be exempted from Section 512(a)(7).

Name and Logo Royalties. Under current law, royalties are excluded from UBTI. Under the proposal, royalties derived from the sale or license of any name or logo of the organization (including trademarks or copyrights) would be required to be included in calculating UBTI.

7. **Suspension of Tax-Exempt Status of Terrorist Supporting Organizations**

The anti-terrorism financing provisions included in the tax proposal largely resemble H.R. 9495, a bill that passed in the House last year but was not voted on in the Senate. Under H.R. 9495, an organization would be entitled to notice of the Secretary of Treasury's intent to designate the organization a "terrorist supporting organization" (a "TSO") that provides material support or resources to another organization that has been designated, under other law, as a "terrorist organization ("a TO"). The pre-designation notice would include, among other things, a description of the material support or resources allegedly provided by the TSO, but only to the extent consistent with national security and law enforcement interests. This is still the case; however, the new tax proposal specifies that the Secretary of Treasury, in its sole discretion, will determine whether (and to what extent) "national security and law enforcement interests" justify withholding all or part of the description of material support from the notice. Despite having received advance notice (and a potential 90-day opportunity to cure), the basis for the TSO designation may remain obscure to the targeted organization. As was the case with H.R. 9495, nothing in the new proposal specifies the evidentiary standard the Secretary of Treasury is required to meet in determining that an organization provided material support or resources to a TO or TSO.

Under the new tax proposal, an organization can challenge the Secretary of Treasury's decision to withhold the description of material support by claiming the determination is erroneous. In that case, the Secretary of Treasury may not move forward with the TSO designation while the appeal is pending in the U.S. district courts. The new proposal also directs the Secretary of Treasury to "establish policies and procedures" that ensure the Department of Treasury complies with "all laws regarding the handling and review of classified information."

Just like H.R. 9495, the new proposal defines "material support or resources" by cross-referencing certain non-tax laws. As drafted, the cross-reference in H.R. 9495 was broad enough to arguably include a knowledge requirement, meaning that the organization has to *know* that it provided material support to a TO or TSO. While the substance of the definition has not changed, [1] the new tax proposal includes a more specific cross-reference for material support, making it more difficult to argue that the broader knowledge requirement applies. This change could mean that an organization could be designated a TSO for providing material support to a TO or TSO, even if the organization is unaware of doing so.

Don't Forget: Self-Defense Lobbying

While the tax code prohibits private foundations from lobbying and imposes limitations on lobbying by other charities, the self-defense exception allows all charities to support or oppose legislation that would "affect the existence of the [electing public charity/private foundation], its powers and duties, its tax-exempt status, or the deductibility of contributions to" the organization. Under that exception, communications with Congress supporting or opposing the applicable aspects of the tax package, or with the general public encouraging them to communicate with Congress to oppose or support the relevant aspects, can fit within the "self-defense exception". (See Treas. Regs. §56.4911-2(c)(4) and §53.4945-2(d)(3)). The exception technically applies to private foundations and to public charities that have elected to use the 501(h) expenditure test to measure their lobbying activity. However, even non-electing charities can rely on the 501(h) definition, including its exceptions, to determine whether they can use lobbying-restricted private foundation funds to support specific activities. Because the IRS might consider a similar communication by a non-electing charity to be lobbying, non-electing charities should consult with counsel to determine if supporting or opposing specific provisions would be outside the applicable definitions and, if not, whether weighing in would constitute a "substantial part" of the charity's overall activities.

Be sure to consider each provision that you wish to support or oppose to evaluate whether it falls within the exception. For example, private foundations could rely on this self-defense exception to lobby Congress on the proposed increases to the private foundation net investment income tax, but a public charity could not. All charities could rely on the exception to address the proposal to terminate the tax status of TSOs. Changes to the UBTI rules likely fall within the self-defense exception for everyone as well, even if your organization isn't currently subject to the tax, because it could be in the future. As always, consult with your counsel to evaluate whether the exception applies to your organization for the specific provision or provisions you want to influence.

These rules govern whether activity constitutes "lobbying" as defined under federal tax law. Such communications may trigger reporting obligations under the Federal Lobbying Disclosure Act, and an organization may not be able to use public funds to pay for them.

Get Involved!

In addition to reaching out directly to legislators, a number of charitable and other nonprofit organizations are forming and joining coalitions aimed at harnessing collective power of the nonprofit sector to influence Congress on the proposed tax bill: National Council of Nonprofits; Council on Foundations; Philanthropy Roundtable; CalNonprofits. We encourage all affected organizations to get involved and make your voice heard.

[1] The new tax proposal also excludes from the definition of material support certain resources approved by the Secretary of State (with the concurrence of the Attorney General) or the Office of Foreign Assets Control (OFAC), including humanitarian aid.