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Top Tax Reform Implications for CAAs

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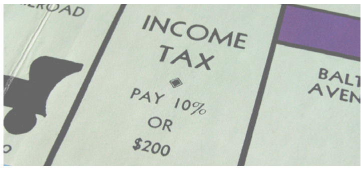
The Tax Cuts and Jobs Act (the Tax Act), which was passed by Congress on December 20, 2017 and signed into law by President Trump two days later, represents one of the most significant overhauls of the U.S. tax code in recent years. In addition to the wide-ranging implications for businesses, employers, and individuals, the Tax Act contains numerous provisions that will affect tax-exempt organizations and their employees. Most provisions in the Tax Act are effective for the tax year beginning January 1, 2018, though some provisions have a different implementation date, as discussed below. This article highlights some of the more important changes affecting Community Action Agencies (CAAs).

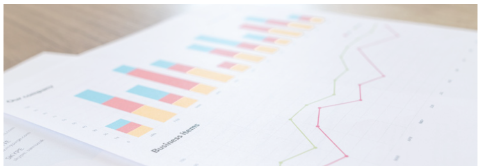
Each CAA should carefully evaluate the potential impact of tax reform on its organization and operations, particularly with respect to employee matters. The IRS is expected to issue additional guidance, including through regulations, to clarify the Tax Act. CAPLAW will continue to monitor the status of the law and issue additional updates and resources as they become available.

Key Provisions for All CAAs

The following changes in the Tax Act are relevant to both public and nonprofit, 501(c)(3) tax-exempt CAAs. Public CAAs should also consult with local government counsel to determine the impact of the Tax Act on public entities and their employees.

- **Updated income tax withholding tables for employees.** The Tax Act changes payroll withholding rates and tables and makes a number of changes affecting individual income tax, including nearly doubling the standard deduction, repealing personal exemptions, and increasing the maximum child tax credit. The Internal Revenue Service (IRS) has released new withholding tables (see 2018 Publication 15) reflecting these changes, and directs employers to begin using the 2018 withholding tables as soon as possible, but not later than February 15, 2018. Employers should continue to use the 2017 withholding tables until they implement the 2018 withholding tables. The 2018 withholding tables are designed to work with existing Forms W-4 that employees have already filed claiming withholding allowances. While employees are not required to complete new Forms W-4, CAAs should expect that some employees may choose to do so.



- **Potential higher health insurance costs due to the effective repeal of the Affordable Care Act (ACA) individual mandate.** Beginning after December 31, 2018, the ACA's individual mandate will be effectively repealed, as individuals who elect not to obtain health insurance coverage will no longer be subject to a penalty (though employees may still be subject to individual mandates imposed by state law in certain states). Many expect that this effective repeal will lead to an increase in the cost of insurance premiums starting in 2019. Note that the ACA's ***employer mandate*** remains in effect, so CAAs with 50 or more full-time employees (including full-time equivalent employees) must continue to offer health insurance that complies with the ACA's minimum coverage and affordability requirements.

Additional Provisions for Nonprofit, 501(c)(3) Tax-Exempt CAAs

In addition to the changes described above, the following provisions are relevant to nonprofit, 501(c)(3) tax-exempt CAAs:

- **Decreased tax incentive for making charitable donations.** Perhaps the greatest uncertainty for nonprofit organizations generally is the impact that tax reform will have on individual charitable contributions. While the Tax Act kept in place the charitable contribution deduction, the doubling of the standard deduction amounts for individuals and joint filers and the limits placed on the mortgage interest deduction and the state and local tax deduction means that a significant number of taxpayers who previously itemized deductions on their tax returns are no longer expected to do so. Though there is certainly a decreased tax incentive to make charitable contributions among taxpayers who no longer itemize donations, CAAs should view this change as an opportunity to reconsider how they communicate with donors. The CAA's board and executive management should coordinate closely to ensure that their donor messaging focuses on the organization's mission and impact, and continue to make compelling cases for giving to the organization. For any large donors and funding sources, the CAA may consider emphasizing the importance of their contributions to the CAA as a result of the reduced incentive to give under the Tax Act.

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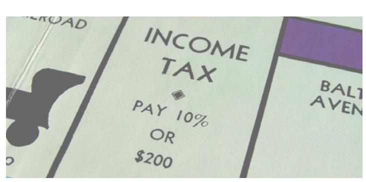
- **Reduction of tax rate on unrelated business taxable income (UBTI).** The Tax Act reduces the corporate income tax rate from 35% to 21%. This lower rate applies to any UBTI generated by a tax-exempt organization, including nonprofit CAAs.

- **Reporting UBTI by separate lines of business or activities.** Though 501(c)(3) tax-exempt CAAs are generally exempt from federal income tax, the IRS imposes an "unrelated business income tax" (UBIT) on income derived from a trade or business regularly carried on by the CAA that is not substantially related to the CAA's tax-exempt functions. An organization that generates $1,000 or more of gross UBTI must report that income on Form 990-T (Exempt Organization Business Income Tax Return). An organization determines its UBTI by subtracting from its gross UBTI all deductions directly connected with the unrelated trade or business.

  Prior to the Tax Act, an organization that operated multiple unrelated trades or businesses determined its UBTI by aggregating income from all such activities and subtracting the aggregate of deductions. Under the Tax Act, however, organizations are now required to compute income separately with respect to each trade or business,



and each separately computed income cannot be less than zero. The organization will then be taxed on the sum of the individual income "silos," less a single $1,000 specific deduction. The result is that a deduction from one unrelated trade or business for a taxable year cannot be used to offset income from a different unrelated trade or business for the same taxable year. However, an organization may use a deduction from one taxable year to offset income from the same unrelated business activity in another tax year, as appropriate.

Take, for example, a nonprofit CAA that operates three different social enterprises—it runs a cleaning enterprise and a catering business, and a fee-for-service weatherization business. The CAA's attorney has determined that any income generated by the enterprises would be UBTI. The CAA has income and allowable deductions for each of the enterprises as follows:

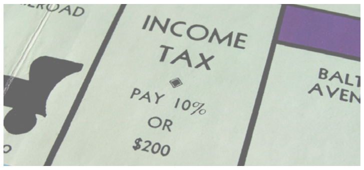
Social Enterprises	Gross Income	Allowable Deductions	Tax Act Income
Cleaning enterprise	$10,000	$15,000	$0
Catering business	$25,000	$10,000	$15,000
Weatherization business	$15,000	$10,000	$5,000
Total	**$50,000**	**$35,000**	**$20,000**

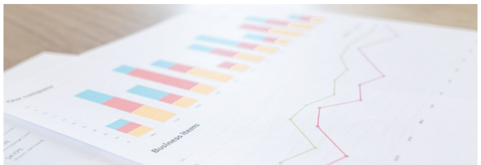
Under prior law, the CAA would calculate its total UBTI by aggregating all income generated under the three businesses, then deducting the sum of all allowable deductions directly connected to the carrying on of each social enterprise. Using the example above, the CAA would report $15,000 ($50,000 - $35,000) in UBTI.

Under the Tax Act, however, each business is viewed separately for UBIT purposes, so the CAA can no longer offset UBTI from activities that generate profits with losses from other unprofitable activities. Thus, using the same example above, the CAA would report $20,000 ($0 + $15,000 + $5,000) in UBTI.

- **Reporting and paying UBIT on expenses for certain transportation fringe benefits provided to employees.** Under the Tax Act, tax-exempt organizations that provide certain "qualified transportation fringe" benefits must report as UBTI, and pay taxes on, all expenses paid after December 31, 2017 for providing these benefits, if the organization wants these benefits to be tax-free (i.e., not deemed as income and not reported as income on Form W-2) to its employees. These "qualified transportation fringe" benefits (as defined in Internal Revenue Code § 132(f)) include: (1) costs associated with providing employee parking on or near the employer's business premises; and (2) any benefit provided to employees for commuting to and from their place of employment, including buses, van pools, transit passes, parking passes, or reimbursements for any of the above.

  One common question is how this affects free parking that a tax-exempt CAA offers its employees. If the parking is available and free to other members of the public—for example, the CAA also allows clients, volunteers, and visitors to park in the parking lot or garage for free—then no "value" is deemed to be provided to the employee, and the free employee parking is not considered a "qualified transportation fringe" benefit under the tax code. In this case, general expenses the CAA incurs in operating the parking lot (including costs associated with leasing the parking lot, providing security and snow removal services, etc.) likely would ***not*** count as UBTI. On the other hand, if the CAA subsidizes (in whole or in part) the cost of its employees to park in a parking lot or garage—for example, a third-party garage operator charges a fee of $5 per day for parking and the CAA pays for some or all of its employees to park there during the workweek, or the CAA operates a parking lot and charges the public





a fee to park but allows employees to park for free—then the free employee parking counts as a "qualified transportation fringe" benefit. In this case, if the CAA wants to continue to offer this benefit tax-free to its employees, then the CAA likely would need to treat the ***expenses*** (not the value) it incurs in providing the benefit (including parking fees and other expenses allocable to the employee use of the parking lot such as leasing costs, etc.) as UBTI and pay taxes at the Tax Act's new 21% corporate rate.

Note that the Tax Act refers to UBTI being equal to the "expenses" incurred by the tax-exempt employer to provide the fringe benefit, but the IRS has not clarified the scope of employer expenses that must be included. The Treasury Department is expected to issue additional guidance on calculating these expenses as well as how tax-exempt organizations must report and pay the tax.

Note: This provision does not affect a tax-exempt organization's ability to allow employees to pay for transportation costs on a pre-tax basis. Thus, a nonprofit CAA can continue to allow employees to pay for transportation or commuting benefits (e.g., mass transit passes or parking fees) with pre-tax income, up to the limits set annually by the IRS. The CAA does not need to report the expenses associated with these programs as UBTI, so long as the CAA is not also providing a "qualified transportation fringe" benefit as described in the examples above.

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