Recent Changes to the Tax Laws Affecting Museums

On December 22, 2017, President Trump signed into law a new set of changes to federal tax law, popularly referred to as the Tax Cuts and Jobs Act. Further changes to the tax law were made as part of the Bipartisan Budget Act of 2018, enacted on February 9, 2018. Below is a summary of the key changes as they might affect charitable museums.

- **Increased Taxation of Charitable Organizations for Certain Fringe Expenses for Employees:** Under the new law, expenses paid by museums and other charitable organizations after December 31, 2017 to provide certain commuting, transportation and parking benefits to their employees will be treated as unrelated business taxable income (UBTI), resulting in a tax paid by the employer.
    - This is a remarkable shift in taxation of museums and other charities, subjecting them to income tax based on *expenses*, rather than *income*.
    - The stated reason for this provision is to put charities on the same footing as fully taxable organizations, for whom these sorts of expenses are no longer deductible (and therefore effectively result in a tax increase) under the new law.
    - However, the compliance burden on museums and other charities will likely be significantly higher than on the private sector, as this new tax will subject many organizations to the unrelated business income tax for the first time.
    - While this new rule clearly applies to commuting and parking benefits given directly to employees of museums and other charities, it is currently unclear whether the new law will also treat amounts that employees choose to exclude from income for certain commuting and parking expenses (currently up to $260 per month), as subject to this tax.
- **Restrictions on Deductions Against Unrelated Business Taxable Income:** The new law will no longer allow losses from one trade or business unrelated to the mission of a museum (or other charity) to offset income generated by another unrelated trade or business. This change could significantly increase the

aggregate amount of unrelated business income tax payable by museums and other charities.

- For example, a museum that generates $100,000 of UBTI by selling items (such a local tourist memorabilia) in its gift shop that are unrelated to its museum function, but also generates a net loss of $100,000 by renting out its parking facilities to the general public, can no longer use its parking losses to offset its gift shop income.

- The law does not define what is a separate "trade or business" for this purpose – the Treasury Department has promised to provide guidance in this regard.

- Pending that guidance, museums that generate UBTI should carefully review their income activities and loss allocations.

- This new rule is effective for a museum or other charity as of the beginning of its first new tax year after December 31, 2017. Losses generated before the beginning of a charity's first new tax year are "grandfathered," and may be used against any future unrelated business taxable income (up to the 80% limit described below).

- **Changes in Application of Unrelated Business Income Tax:** The new law changes the tax rates for charities subject to the unrelated business income tax, and also changes the extent to which losses can offset income even within the same trade or business.

  - For charities in corporate form, the new tax rate for UBTI is 21%. For some museums, this will be a rate reduction. However, for museums that previously paid tax in the lower 15% corporate income tax bracket, this will be a rate increase.

  - For museums in trust form, UBTI will be taxed at rates of up to 37%.

  - As noted above, charities can no longer offset income from one trade or business against losses from another. Charities can still use past losses from one trade or business against income in that same trade or business in future years, but only up to 80% of UBTI in each future tax year. Accordingly, it will no longer be possible to offset 100% of UBTI in any given year using losses from past years (even with regard to the same trade or business).

- **Excise Tax on Executive Compensation for Exempt Organizations:** The new law will impose a 21% excise tax on museums (and other tax-exempt organizations) for compensation in excess of $1,000,000, and on excessive severance packages, paid to certain employees of museums and other charities.
    - Compensation will be treated as paid (whether or not actually paid) whenever there is no substantial risk of forfeiture, and includes compensation from certain controlling, controlled, supporting and supported organizations.
    - The tax on excessive severance payments would generally apply to the extent that a severance package exceeds three times the employee's base salary (measured over a five-year period prior to termination of employment).
    - This new tax does not affect the so-called "intermediate sanctions" rules of section 4958 of the Code, regarding reasonableness of compensation – those rules continue to apply, separate and apart from the rules regarding this new excise tax.
- **Income Exclusion for Advance Refunding Bonds:** The new law will eliminate the income tax exclusion for income from bonds issued to provide advance refunds on other bonds.
- **Limitation of Rehabilitation Credit:** The new law will reduce or eliminate certain credits currently afforded for rehabilitation of historic buildings.
- **Effects on Charitable Giving Incentives:** The new law will make a number of changes to the personal income tax rules which may affect charitable giving incentives, at least through 2025, when these changes will sunset.
    - The new law will increase the 50% limitation for cash contributions to public charities and private operating foundations, including museums, to 60%.
        - Because of an apparent mistake in the drafting of this provision, it appears that this higher 60% limitation will apply only when a taxpayer makes no charitable gifts in a given tax year other than cash gifts to public charities or private operating foundations. Any gifts to private nonoperating foundations, and any gift of appreciated property, would effectively reduce this limitation back to 50%.
        - Taxpayers may still roll over unused charitable income tax deductions for up to five additional years.

- Lower-income donors may receive less of a benefit for charitable contributions due to increases in the standard deduction (to $12,000, or $24,000 for married taxpayers filing jointly).
- The new law suspends the so-called Pease limitations on itemized deductions, which reduced the effectiveness of charitable deductions for certain high-income taxpayers.
- The new law effectively doubles the base estate tax exemption amount to $11.18 million starting in 2018 (indexed thereafter for inflation).

- **"Newman's Own" Exception to Excess Business Holdings Rules:** The "excess business holdings" rules generally prevent private foundations (including private operating foundations) from holding large interests in business enterprises. In order to avoid having to sell its Newman's Own business, the Newman's Own Foundation has for many years attempted to change the law to allow private foundations to hold and retain active business interests under certain conditions. In February 2018, as part of the Bipartisan Budget Act of 2018, the Foundation succeeded. This new rule will exempt business interests held by private foundations from these rules as long as the following conditions apply:
  - 100% of voting stock is held by the private foundation, all of which was acquired by gift or bequest, not purchase.
  - Net profits are distributed up to the controlling foundation no later than 120 days after the close of each taxable year.
  - The business is operated independently of the foundation, with an independent board and no substantial contributor or family member involved in the business or loaning money to the business.

  If structured properly, this new rule could allow museums and other private foundations to receive and retain gifts or bequests of active businesses.

- **Proposed Minimum Hours for Art Museums – Not Enacted, But Worth Monitoring:** An early version of the new tax law would have imposed a requirement that an art museum organized as a private operating foundation must be open to the public a minimum of 1,000 hours per year. An art museum that failed to do so would lose its "operating foundation" status, and would instead be subject to the 5% distribution requirement for private nonoperating foundations. This provision was not included in the final version of the new tax law that was enacted, but it may be re-introduced in future legislation.

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