Nonprofit Law Alert: Pending Tax Code Proposals Carry Sweeping Consequences for Nonprofits

While the Internal Revenue Code hasn't seen a major overhaul since 1986, there is a likely chance – and perhaps a fear – that the Tax Code as we know it today may not be the tax law next year. On November 9, 2017, the Senate Finance Committee released its tax reform proposal, which came one week after the House of Representatives proposed its own tax reform bill. Each pending proposal carries with it consequences – both positive and negative – for nonprofit businesses. Although the proposals do not explicitly target nonprofits, which account for about 10 percent of private sector employment in the United States, experts and industry leaders are emphasizing each proposal's respective impact on nonprofits across several critical areas.

Affordable Housing

One key area where the Senate and the House noticeably diverge in their respective tax reform proposals is private activity bonds. Unlike the House's tax reform bill, which eliminates private activity bonds, the Senate's proposal retains private activity bonds, which generate 4 percent Low-Income Housing Tax Credits. These Tax Credits remain a vital tool in both the development and the preservation of affordable housing, and their potential loss would create a devastating impact on renters across the nation.

Although the House's bill preserves the Low-Income Housing Tax Credit for now, its repeal of the private activity bond rules would eliminate the availability of Tax Credits for projects where at least 50 percent is financed by tax-exempt private activity bonds. This would result in a net decrease in Low-Income Housing Tax Credits available for affordable housing projects across the nation, as tax-exempt private activity bonds have traditionally provided an alternative source of Low-Income Housing Tax Credits to attract developers. In the end, the proposal to eliminate the issuance of private activity bonds would likely leave large gaps in infrastructure financing, which is likely to have a devastating effect on many aspects of nonprofits.

Created as part of the Tax Reform Act of 1986, the Low-Income Housing Tax Credit program produced over 2.4 million low-income housing units between 1986 and 2016. Thus, "A repeal of the Low-Income Housing Tax Credit," according to Andrea Ponsor, Executive Vice President for Policy at Stewards of Affordable Housing for the Future, "would see protection and preservation of affordable housing grind to a near halt."

Although it remains a positive development that the Senate's proposal retains private activity bonds and that both proposals retain the Low-Income Housing Tax Credit, the fact that private activity bonds are left out of the House's bill altogether warrants fear that they will eventually be cut, thus subsequently creating a negative impact on the availability of the Low-Income Housing Tax Credit.

Tax-Exempt Financing

As it currently stands, according to Richard A. Newman of Arent Fox LLP, "tax-exempt financing provides a unique financial incentive for all eligible nonprofits to purchase or develop headquarters and other facilities used in furtherance of their charitable purposes. Tax-exempt financing typically yields interest rates in the range of two percentage points per year lower than conventional debt, which may in turn result in other cost savings and benefits. As such, the use and benefit of this form of financing for nonprofits can be seen throughout the nation, as more eligible nonprofits seek to purchase or develop real estate."

However, as the House's tax reform bill seeks to eliminate private activity bonds (see above), the corresponding negative impact on the entire nonprofit sector would be severe. For instance, although nonprofit hospitals issue tax-exempt bonds to finance capital projects, under the House's tax reform bill, interest on newly issued private activity bonds would no longer be tax-exempt. As a result, financing options for lower-rated healthcare organizations would decrease and the cost of capital would increase, according to S&P Global Ratings. "From a credit perspective," said S&P, "higher borrowing rates can lead to budget imbalances, a challenge for all, and a hallmark of struggling credits." Tom Nickels, executive Vice President of the American Hospital Association, also noted how the tax plan could negatively impact healthcare providers, explaining: "If hospital access to tax-exempt financing is limited or eliminated, hospitals' ability to make investments in new technologies and renovations in the future will be challenged."

Further, not only would the House's tax reform bill eliminate the issuance of new private activity bonds, but the bill would also create a new penalty – taxing the interest on private activity bonds issued on or after January 1, 2018. This change would strike from the Tax Code sections 142 (Exempt Facility Bonds), 143 (Qualified Mortgage Bonds and Qualified Veterans' Mortgage Bonds), 144 (Qualified Small Issue Bonds, Qualified Student Loan Bonds, and Qualified Redevelopment Bonds), and 145 (501(c)(3) Bonds), as well as sections 146 and 147, which both set forth operating rules for interest on private activity bonds to qualify for the exemption from federal income tax under the Tax Code. Taxing interest on the qualified private activity bonds, as the House's bill proposes, would increase the cost of borrowing for charitable, scientific, literary, educational, and other nonprofit organizations to fund public projects and may even prevent some projects from being funded altogether.

On the other hand, although the Senate's proposal also includes measures to limit tax-exempt financing for nonprofits, the Senate's proposal preserves tax-exempt municipal bond financing for capital projects undertaken by nonprofit hospitals and other eligible nonprofits. According to the Merritt Research Services, outstanding end-of-year hospital debt totaled nearly $301 billion in long-term bonds and nearly $21 billion in short-term debt, most of which issued as tax-exempt bonds.

If the tax exemption was to be eliminated, as the House's bill has proposed, hospitals would have to pay interest rates that were 0.25 percent to 0.5 percent higher than in the current market, as "bond investors would demand higher interest rates in lieu of receiving the interest income free of federal taxes," explains John Cheney, managing director of Ponder & Co. This is why the consensus of nonprofit leaders – particularly in the healthcare sector – prefer the Senate's proposal over the House's bill.

Charitable Deductions

One largely negative consequence of the proposed Tax Code revisions is its impact on charitable giving. Both proposals would seek to eliminate most individual deductions while simultaneously doubling the standard deduction. As a result, experts at the Tax Policy Center predict that only five percent of taxpayers will elect to itemize their deductions, meaning 95 percent of taxpayers would receive no tax incentive for donating to the work of charitable nonprofits. Currently, taxpayers that elect to itemize their deductions pay approximately 60 cents on the dollar when they donate to charitable causes. However, the proposed revisions would cap the amounts of itemized deductions to $100,000 for individual taxpayers and $200,000 for joint taxpayers. As a result, upwards of $17.6 billion in annual giving is estimated to evaporate, according to an American Enterprise Institute ("AEI") simulation.

Currently, although only 25% of Americans elect to itemize their deductions, the AEI found – among those who do itemize – the average amount that Americans write off is well below the proposed threshold limits: $15,400 for individual taxpayers and $26,500 for joint taxpayers. As such, the proposed revisions would only affect approximately 329,000 taxpayers; however, the consequences of the proposed revisions on this group would be severe. According to Giving USA's annual report, gifts of $100 million or more totaled at least $3.3 billion in 2015. Further, while a desire to make a difference (73.5 percent) and personal satisfaction (73.1 percent) represent the main motivators in charitable giving, according to a 2014 United States Trust Study of High Net Worth Philanthropy, the tax incentive of charitable giving was still cited by 34.4 percent of respondents. Thus, although many taxpayers will continue to donate to charity notwithstanding the erasure of the tax incentive, large gifts from wealthy donors could, and likely would, decrease significantly.

All is not lost, however, as other experts remain optimistic about the positive effect that said proposals could have on the nonprofit sector. In theory, according to The Heritage Foundation, a rising economic tide – should the revisions create one – could kick back more money to donors, thereby lifting nonprofits. "If tax reform is done properly," explains Adam Michel, policy analyst at The Heritage Foundation, "there's growth that happens as a result. When the economy is doing well, and people have more money in their pockets, they donate more."

Conclusion

In sum, both the House of Representatives and the Senate have proposed significant tax reform measures that aim to significantly impact nonprofit organizations. Specifically, each of the proposals aims to have consequences in the areas of affordable housing, tax-exempt financing, and charitable giving – among other nonprofit concerns. As to which of the suggested revisions to the Internal Revenue Code by either, or both, proposals will be adopted, only time will tell; for the time being, nonprofit organizations nationwide have no choice but to wait and see.

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