An Analysis of the New Federal Tax Law on Charitable Nonprofit Corporations

Since Legal Assistance of Western New York ("LawNY") launched its Community Development & Economic Justice Project ("CDP") in 2016, CDP staff have adopted a model of "community lawyering," embracing the notion that community groups and nonprofit organizations possess deep connections with the communities they serve and can help legal services organizations pinpoint the services our communities most desperately need. Recognizing the strength of such a model, the CDP considers the financial and organizational well-being of our nonprofit community partners and clients to be of paramount concern to our communities' well-being. While even minor legislative and regulatory changes can have an unexpected effect on the sustainability of these organizations, the impact the new Federal Tax Cuts and Jobs Act will have on charitable nonprofit corporations is still unknown and could deal a substantial blow to the fiscal health of many organizations. To make matters worse, these changes may curtail donations to new startup nonprofits, including those contributions made to organizations providing vital disaster-relief services in times of emergency.

Nonprofit Legal Changes

Legal changes in the nonprofit world are far from unexpected, especially for New York State Nonprofit Corporations. The New York Revitalization Act of 2013, and its subsequent amendments, brought many sweeping changes to the way nonprofits in New York state handle conflict of interests, audits, amendments to certificates of incorporation, and the dissolution process. On the federal side, in 2014, the IRS streamlined the process for certain organizations applying for federal tax exempt status under Internal Revenue Code (IRC) Section 501c3, allowing eligible organizations to apply for tax exemption through a short, three-page 1023-EZ form, instead of the lengthy 26-page long 1023 Form. While there are a few commentators who criticize these and other changes in the nonprofit sphere as opening the floodgates for ineligible and ill-prepared charitable nonprofits, these changes have generally benefited newly formed and pre-existing organizations and have had the best interests of nonprofit organizations in mind.

The new Federal Tax Cuts and Jobs Act, passed by the Senate in December 2017, and then signed into Law, however, brings about the potential for a significant decrease in aggregate taxpayer donations that could impact not only the charitable well-being of nonprofit groups, but could also take away a major benefit of applying for tax exempt status under IRC 501c3. There are at least three major changes in the Federal Tax Cuts and Jobs Act that will likely impact nonprofit organizations: (1) the increase in the standard deduction; (2) the limit on state and local tax deductions, and; (3) the doubling of the estate and gift tax exemptions. These changes in the New Federal Tax Cuts and Jobs Act all have the potential to decrease charitable giving to nonprofits.

Increasing the Standard Deduction

The increase in the standard deduction from $6,350 to $12,000 for single individuals and from $12,700 to $24,000 for married couples is projected to substantially reduce the number of taxpayers that itemize their deductions.[1] There are currently estimates that the number of taxpayers that itemize their deductions could see a decrease from 30% of all taxpayers in 2017 to 6% in 2018. [2] As the charitable contribution deduction is only available for those taxpayers who itemize their deductions, the decrease in itemized tax returns is significantly related to the potential for charitable giving. While it is difficult to speculate on whether taxpayers will still be motivated to donate to charitable groups without the benefit of a tax deduction, studies have shown that “83 percent of itemizers reported donating any amount of charitable giving… compared to 44 percent of non-itemizers.” [3] Other studies state that charitable giving is projected to decrease anywhere between 12 billion and 20 billion annually upon implementation of the new tax law. [4] The projected loss of these contributions may result in a loss of about 220,000 to 264,000 jobs nationally in the nonprofit sector. [5]

Those taxpayers who still wish to maintain their level of charitable contributions will likely consider postponing all their charitable contributions to a single year in order to maximize their itemized deductions, in a practice call “bunching.” [6] The utility of this practice for non-profits, however, relies on several assumptions, including the presumption that taxpayers will want to bother with the practice when it’s not an annual occurrence, and whether nonprofits can adapt to prolonged periods between taxpayer contributions without harm to the organization.

Limits on State and Local Tax Deductions

Going hand-in-hand with the increase in the standard deduction, the decrease in the amount of state and local taxes that can be deducted by those taxpayers that itemize will also serve as a disincentive to taxpayers who itemize their deductions. As the amount of state and local taxes that can be deducted has dropped to $10,000, it will be more difficult for taxpayers to justify itemizing deductions over opting for the standard deduction. This additional push towards opting for a standard deduction will once again have a significant impact on those individuals and families that are now unable to financially justify making charitable contributions.

Doubling of Estate and Gift Tax Exemptions

A less direct, but just as impactful change in the federal tax law is in the form of a doubling of the estate and gift tax exemption. While this change doesn’t necessarily push more taxpayers into opting for a standard deduction, it does make charitable estate bequests less attractive for donors. Because the tax on leaving or gifting property or money to family members will decrease due to the increased exemption, the desirability of charitable tax planning is diminished. [7] In a previous tax year when the estate tax was repealed, charitable bequests dropped significantly, 37 percent from the prior year. [8] Therefore, changes in estate taxes can, and should be expected, to have a large impact on charitable giving.

Predicting the Impact on Charitable Nonprofits

For many nonprofit organizations, charitable contributions are only one piece of the pie that comprises their total gross revenues. Grants from private foundations, corporations, and federal, state, and local agencies are another large piece of the revenue, along with membership dues, fees for services, and sales of goods. It can be surmised, therefore, that the greatest impact of the Federal Tax Cuts and Jobs Act will be on those organizations that are newly formed and cannot rely on ongoing grants or other recurring revenue streams. Likewise, those organizations that generate most of their revenue from charitable contributions will be impacted. The wealthiest donors, who will still benefit from itemizing their deductions, will continue donating, and even have the ability to donate more of their adjusted gross income, thanks to a beneficial provision in the new tax law that raises the cap on charitable giving to 60% of Adjusted Gross Income from 50%. However, many of these wealthy donors will potentially focus their spending on larger nonprofit organizations, meaning that the organizations most likely to be hurt from a reduction on charitable donations may be newer, smaller nonprofits. [9]

"As these new nonprofits don't have the luxury of time to apply for grants or to build up sales of goods and services, they rely primarily on the public's donations during times of crisis."

The Impact on New Nonprofits Organized to Provide Disaster-Relief Support

In line with the concern that newer, smaller nonprofits have the potential to be hurt most from the Federal Tax Cuts and Jobs Act is how this change will impact new charitable nonprofits that are established to address domestic and international disaster-relief efforts. In 2017, Charity Navigator reported an increase of donations of 5.8% to international charities; donations such as these came

primarily from individual donors.[10] As these new nonprofits don't have the luxury of time to apply for grants or to build up sales of goods and services, they rely primarily on the public's donations during times of crisis. An anticipated reduction in taxpayers utilizing the charitable contribution deduction could have the unexpected impact of hindering new disaster-relief organizations from raising the funds they need to support and assist those impacted by natural disasters, such as Hurricanes Irma and Harvey.

Even those disaster-relief organizations that are not newly formed will potentially see a decrease in contributions due to the tax law. A study from the National Survey of Nonprofit Government Contracting and Grants found that “human service nonprofits that rely mostly on donations tend to be mid-sized,” and twice as many large nonprofits as small nonprofits count on government support as their largest source of funding. [11] This again indicates the potential for a decrease in overall revenue, not only for small nonprofits, but also mid-size nonprofits that tend not to rely on government funding and grants in the same way larger organizations do. Although larger nonprofits can focus time and money on addressing disasters as they happen, it’s undeniable that the grassroots and intercommunity efforts that many mid-size and smaller nonprofits make to handle these types of crises are invaluable.

“...it’s especially important now for nonprofits to compare and contrast this year’s quarterly contributions to prior years to identify any potential decreases in revenue.”

Conclusion

Undeniably, determining the exact impact of the Federal Tax Cuts and Jobs Act on nonprofit organizations is tricky. We may discover over the next year that donors switching from itemized deductions to standardized deductions are not swayed from donating to their charities of choice. Moreover, small and mid-sized nonprofits and disaster-relief organizations may adapt by choosing to operate under larger nonprofits in order to benefit from wealthier donors who in turn benefit from the tax law’s increased cap on charitable giving and decreased tax rate. It is also possible we may not see the true impact of the Law until a few tax cycles have passed, and taxpayers have completely adjusted their charitable contributions to maximize their deductions.

Regardless of our speculation, however, it’s especially important now for nonprofits to compare and contrast this year’s quarterly contributions to prior years to identify any potential decreases in revenue. Depending on what nonprofit organizations are seeing on a micro-level will likely determine the overall impact of the Federal Tax Cuts and Jobs Act on the health and well-being of charitable nonprofit organizations.

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