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IRS

New Unrelated Business Income Rules

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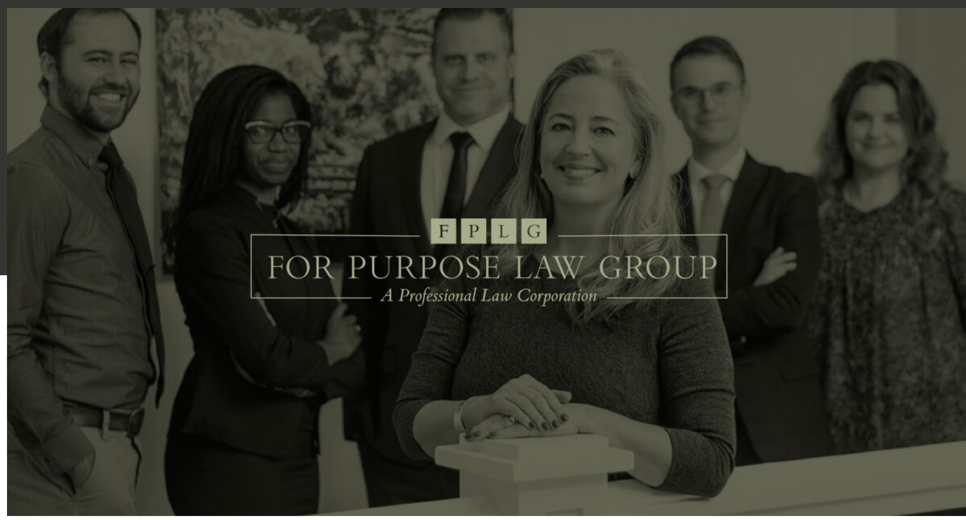

In last December's overhaul of the federal tax code, lawmakers included four provisions directly affecting certain nonprofits. One of the new laws makes dramatic changes to Internal Revenue Code section 512(a), the unrelated business income tax (UBIT) rules.

Multiple Unrelated Businesses

The key change affects those groups that have more than one unrelated trade or business.

Before the Tax Cut and Jobs Act of 2017, tax-exempt organizations that had more than one unrelated business were permitted to aggregate deductions relating to one business to offset income earned by a second (or third) business subject to UBIT. An organization with a profitable business could reduce its net income subject to UBIT by setting off the expenses arising from another business that operates as a loss. This could result in substantial tax savings.

Under the new rule, organizations with more than one unrelated trade or business must calculate UBI for each of them separately. They can no longer use deductions attributable to one business to offset the income from a separate business. In addition, gains and losses must be calculated and applied separately. If a certain activity has a net loss for the year, that loss may not be applied to reduce income from another activity operated by the group.

Typically, when lawmakers enact changes to existing laws, they include delayed effective dates to allow the affected individuals or entities to plan for, and put in place, an orderly transition. In this case, no such accommodation was made. The new rule became effective immediately; that is, for tax years beginning in 2018.

"To properly calculate … taxable income … under the new law, exempt organizations will need to assure that activities are reasonably defined." That requires a sophisticated analysis of whether "multiple income-producing endeavors are viewed separately or aggregated and viewed as one activity…" and will affect when losses from "unprofitable activities may be offset against net income from profit-producing activities."

Dennis Walsh, CPA, in *Planning for the UBTI Changes*, explains that a key omission of the final, enacted, version of the new tax law as well as of the Senate Finance Committee report is "discussion of criteria for defining a single trade or business activity." He suggests that "[u]ntil regulations and administrative guidelines are issued on distinguishing and disaggregating activities when required, organizations and their advisors can glean insights from the IRS 2013 Colleges and Universities Compliance Project (CUCP) report." Accordingly, Mr. Walsh recommends that exempt organizations consider the following questions regarding any current or planned UBI activities: (1) "Is the trade or business activity appropriately defined, or might it be reasonably viewed as comprising more than one activity?" and (2) "If a particular trade or business, appropriately defined, has a history of recurring losses, is it supportable as an activity engaged in for profit?"

Net Operating Losses

There are additional changes in the new law related to "net operating losses."

Under the old law, organizations were allowed to carry them back for two years and carry them forward for 20 years. The entire amount could be used to offset 100% of the taxable income in a current year.

Under the new law, the carryback of losses has been eliminated entirely. However, operating losses can be carried forward indefinitely. Also, for tax years beginning January 1, 2018, an organization's net operating loss deduction is reduced to only 80% of taxable income. There is a special transition rule, though: Net operating losses from pre-2018 that are carried forward to a taxable year beginning on or after December 31, 2017, are not subject to this limitation.

A Bit of Good News

If, and when, an organization must pay unrelated business income tax, the tax rate – itself – becomes relevant. The new law wiped out the former corporate tax rate structure, replacing it with a flat 21% rate. For organizations with large amounts of unrelated business income, that may mean a substantial reduction in the *amount* of tax they must pay.

There's a catch, though. Organizations that generally report unrelated business taxable income of less than $90,385 will face a jump in the UBI tax. That's because the new tax code gets rid of what was a tax break: a 15% tax rate on the initial $50,000 of taxable income.

Conclusion

The changes to the unrelated business income rules are complex and will have substantial financial implications for certain organizations. It may be necessary or advisable to substantially restructure or reconsider current or contemplated activities. Any organization navigating its way through this new law needs professional advice and assistance to help steer the course.

— Linda J. Rosenthal, J.D., FPLG Information & Research Director