Tax Notes

Federal Tax Reform: Impact on Unrelated Business Income

By Melissa Modelson, CPA, Tax Manager

The Tax Cuts and Jobs Act (TCJA) made several changes to the tax laws affecting tax-exempt organizations, including the reporting and taxation of unrelated business taxable income (UBTI). These changes include the:

- separate reporting of unrelated business income for each trade or business conducted by the organization,
- new unrelated business income tax rates, and
- elimination of the two-year net operating loss (NOL) carryback provision.

Separate Reporting for Each Unrelated Trade or Business Activity

Unrelated business taxable income is the gross income earned by an exempt organization that is (1) unrelated to the exempt organization's purpose, (2) is regularly carried on, and (3) is a trade or business, less allowable deductions directly related to the unrelated business activity.

Before the TCJA, exempt organizations with several streams of unrelated business income were able to net all of the activities on an aggregate basis. If the net unrelated business activity generated a loss, the organization was required to carry that loss back two years and forward for a maximum of 20 years.

Under the TCJA for tax years beginning after December 31, 2017, each activity that generates unrelated business income will need to be calculated separately for each trade or business activity. Activities that generate a loss can no longer offset the income generated by other trade or business activities. Separate NOL schedules will need to be maintained in order to track each activity's losses, and will only be able to be netted against unrelated business income generated by that activity in the future.

For example, if an organization generated unrelated business income from partnership investments and advertising income, the gain from its investments cannot be netted against a loss from its advertising activity.

Organizations that were not paying income tax in the past may be required to do so going forward because of this law change.

The TCJA does not define how an activity will be classified. For example, if an exempt organization is invested in multiple limited partnerships that generate unrelated business income from various trade or business activities, it is unclear if each of those partnership investments need to track and report each trade or business separately or if they can be grouped together as one unrelated business generating activity classified as an investment activity reportable on Form 990-T. Further guidance is expected to be issued by the IRS to clarify this issue.

Federal Tax Rates

The rate at which unrelated business income is taxed depends on how a tax-exempt organization is organized. Tax-exempt organizations formed as corporations are taxed at corporate rates while those formed as trusts are taxed at trust rates.

Prior to the TCJA, the corporate tax rate was a graduated rate with a top rate of 35%. For tax years beginning after December 31, 2017, the corporate tax rate is reduced to a flat rate of 21%. In addition, the corporate alternative minimum tax was repealed.

.

For those tax-exempt organizations taxed as trusts, the trust tax rates were reduced as well, with the highest trust tax rate being reduced from 39.6% to 37%, although the alternative minimum tax still remains in effect.

The change in tax rates may have a significant impact on organizations currently paying income tax on its unrelated business income which will need to be factored into its estimated payments for 2018.

Net Operating Loss Carryback Provision

Prior to the TCJA, an organization was required to first carryback a net operating loss (NOL) two years (unless electing otherwise) and carry the remaining NOLs forward 20 years. The NOL could be used to offset 100% of the organization's taxable income in the year the NOL was utilized.

Under the TCJA, NOLs generated in tax years beginning after December 31, 2017 can no longer be carried back; however, they can be carried forward indefinitely. In addition, the NOLs generated in tax years beginning after December 31, 2017 can only be utilized to offset 80% of the taxable income in the current year. This change will require organizations to track their pre-TCJA losses and their post-TCJA losses, as the losses generated prior to December 31, 2017 would not appear to be subject to the 80% limitation.

Again, this change in the law may require organizations that historically were not subject to tax in the past to begin paying income tax.

Additional clarification is needed from the IRS regarding the usage of NOLs that are subject to the 80% limitation and those that are not when they are utilized in the same year. For example, assume an organization has $10 million of taxable income in 2019, a $9 million NOL from 2017, and a $1 million NOL from 2018. The organization would be able to utilize the $9 million NOL since it is not subject to the 80% limitation. However, it is unclear if 80% of the $1 million NOL would then be allowed to be utilized, or if the IRS will state that the 80% limitation was already met by the 2017 NOL and, thus, disallow the 2018 NOL.

Updating the Tax Code and Regulations

These new tax provisions will now have to be incorporated into the Internal Revenue Code and Treasury Regulations. Through this process, additional information will be provided to clarify the language used. As more guidance is provided, we will continue to keep you informed with future Thought Leadership communications.

Contact Us

If you have questions regarding how the tax reform will apply to your tax-exempt organization, please contact Melissa Modelson, CPA, Tax Manager at mmodelson@pkfod.com, Garrett M. Higgins, CPA, Partner at ghiggins@pkfod.com, or a member of your tax-exempt client service team at PKF O'Connor Davies.

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, nine offices in New York, New Jersey, Connecticut and Maryland, and more than 700 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 29th on *Accounting Today'*s 2018 "Top 100 Firms" list and is recognized as one of the "Top 10 Fastest-Growing Firms." PKF O'Connor Davies is also recognized as a "Leader in Audit and Accounting" and is ranked among the "Top Firms in the Mid-Atlantic," by *Accounting Today.* In 2018, PKF O'Connor Davies was named one of the 50 best accounting employers to work for in North America, by *Vault*.

PKF O'Connor Davies is the lead North American representative in PKF International, a global network of legally independent accounting and advisory firms located in over 400 locations, in 150 countries around the world.

Our Firm provides the information in this e-newsletter for general guidance only, and it does not constitute the provision of legal advice, tax advice, accounting services, or professional consulting of any kind.