The new unrelated trade or business loss offset prohibition

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As the Tax Cuts and Jobs Act (TCJA) provisions were being formulated and discussed between lawmakers in both chambers of Congress in late 2017, one provision of particular interest to the tax-exempt community as a whole was related to a previous proposal initially drafted in the 2014 Camp Tax Reform proposed legislation.

The new law: Unrelated business taxable income separately computed for each trade or business

Section 501(a) exempts certain organizations from federal income tax. Such organizations include:

- Tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations)
- Religious and apostolic organizations described in section 501(d)
- Trusts forming part of a pension, profit-sharing or stock bonus plan of an employer described in section 401(a)
Unrelated business income tax, in general

An exempt organization generally may have revenue from four sources:

1. Contributions, gifts and grants
2. Trade or business income that is related to exempt activities (e.g., program service revenue)
3. Investment income
4. Trade or business income that is not related to exempt activities

The federal income tax exemption generally extends to the first three categories, and does not extend to an organization’s unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income. This is the case for social clubs (described in section 501(c)(7)), voluntary employees’ beneficiary associations (sec. 501(c)(9)), and organizations and trusts described in sections 501(c)(17) and 501(c)(20) as provided in section 512(a)(3).

The unrelated business income tax (UBIT) generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions. These rules are set forth in sections 511–514 of the Internal Revenue Code. An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business as long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities. See Treasury Regulations (Treas. Reg.) section 1.501(c)(3)−1(e). Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

Organizations subject to tax on UBI

Most exempt organizations are subject to the tax on unrelated business income (UBI). Specifically, organizations subject to UBIT generally include:

- Organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts); see section 511(a)(2)(A)
- Qualified pension, profit-sharing and stock bonus plans described in section 401(a); see section 511(a)(2)(A)
- Certain state colleges and universities; see section 511(a)(2)(B)

Exclusions from unrelated business taxable income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties and certain rents (sections 511–514), unless derived from debt-financed property or from certain 50–percent controlled subsidiaries. See section 512(b)(13). Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers or employees of a charitable organization. In addition, special UBIT provisions exempt from tax the activities of trade shows and state fairs, income from bingo games and income from the distribution of low-cost items incidental to the solicitation of charitable contributions.

Specific deduction against unrelated business taxable income

In computing unrelated business taxable income, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss (NOL) that will be carried forward to another year. See section 512(b)(12).
Operation of multiple unrelated trades or businesses: Prior law

An organization determined its unrelated business taxable income by subtracting from its gross UBI deductions directly connected with the unrelated trade or business. See section 512(a).

Under regulations in Treas. Reg. section 1.512(a)-1(a), in determining unrelated business taxable income, an organization that operated multiple unrelated trades or businesses could aggregate income from all such activities and subtract from the aggregate gross income the aggregate of deductions to arrive at a taxable income amount.

As a result, an organization under prior law could use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

Operation of multiple unrelated trades or businesses: The new law

The U.S. House of Representatives made no provision for this new law; however, the Senate did provide for an amendment in its version of the TCJA.

For an organization with more than one unrelated trade or business, the provision requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under section 512(b)(12). The organization’s unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under section 512(b)(12). A net operating loss (NOL) deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the provision is that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year. The provision generally does not, however, prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business in another taxable year, where appropriate.

The provision is effective for taxable years beginning after Dec. 31, 2017. Under a special transition rule, NOLs arising in a taxable year beginning before Jan. 1, 2018, that are carried forward to a taxable year beginning on or after such date are not subject to the rule of the provision. This is good news for loss carryovers to the 2018 tax year in that such NOL carryovers may offset income from any unrelated trade or business.

Two big questions remain which are not addressed in new code section 512(a)(6):

1. Does section 512(a)(6) interplay with another provision provided for in the TCJA which limits utilization of losses which arise in tax years beginning after Dec. 31, 2017?
2. What is meant by “trade or business,” and separating each from the other, and will any grouping be allowable (e.g., including but not limited to, by industry (all real estate is one trade or business), or by like activity (e.g., all advertising is one trade or business, although it is generated in five different publications, on a website, or by other methods))? 

Statutory language of the new rule

The following language is taken from the actual statute:

Unrelated business taxable income separately computed for each trade or business activity.

New section 512(a)(6): Special rule for organization with more than one unrelated trade or business. In the case of any organization with more than one unrelated trade or business:

A Unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to each such trade or business and without regard to subsection (b)(12),
(B) The unrelated business taxable income of such organization shall be the sum of the unrelated business taxable income so computed with respect to each such trade or business, less a specific deduction under subsection (b)(12), and

(C) For purposes of subparagraph (B), unrelated business taxable income with respect to any such trade or business shall not be less than zero.

(b) EFFECTIVE DATE

(1) IN GENERAL. Except to the extent provided in paragraph (2), the amendment made by this section shall apply to taxable years beginning after Dec. 31, 2017.

(2) CARRYOVERS OF NET OPERATING LOSSES. If any net operating loss arising in a taxable year beginning before Jan. 1, 2018 is carried over to a taxable year beginning on or after such date

(A) Subparagraph (A) of section 512(a)(6) of the Internal Revenue Code of 1986, as added by this Act, shall not apply to such net operating loss, and

(B) The unrelated business taxable income of the organization, after the application of subparagraph (B) of such section, shall be reduced by the amount of such net operating loss.

Analysis of the new rule

Observing the contents of the above new statute, the following statements apply:

1) Each trade or business stands on its own.
2) All the identified trade or businesses in 1) above, that have income, are added together.
3) None of the trade or businesses that have losses are taken into account (can't offset the income calculated in 2) above).
4) The trade or businesses with losses, in 3) above, separately account for those disallowed losses and those losses may be carried forward to future tax years, indefinitely, and may only be used to offset each one of those trade or businesses specific income which may be generated in a future year (i.e., loss from trade or business A, may only offset future year income from trade or business A, and loss from trade or business B, may only offset future year income from trade or business B).
5) A tax exempt’s unrelated business taxable income becomes the amount in 2) above (before a specific deduction).
6) A pre–2018 tax year NOL carry over into 2018 does not have to be separated into its own separate trade or business components. This tax attribute carries forward as one loss amount.
7) All income combined from all trade or businesses and which is determined to be unrelated business taxable income calculated in 5) above, may be offset by the pre–2018 NOL carry over deduction.

The need to segregate income between various trades or businesses is required under this new statute, but no guidance is provided in the legislative history as to how this separation is defined. For example:

- Will an organization be able to group all of its real estate together as one trade or business, or will each piece of real estate be required to be separately accounted for?
- Will an organization with investments in pass-through entities be able to group those investments together under the argument that the exempt organization is in the trade or business of investments, or investing, or will the organization be required to report each pass-through investment as a distinct and separate trade or business?
- Can an exempt entity group all activities together in the same industry? For example, will all real estate activities be considered one trade or business for this purpose? Will all advertising be considered another trade or business?

Future guidance must address the above open items.

One last question arises: are there any other provisions included in the TCJA that could interplay with
the separate trade or business rule as provided for in new section 512(a)(6)? The answer to that question is yes in the form of an amendment to the net operating rules located in section 172.

Modification of the NOL deduction: Prior law

An NOL under prior law (and in current law) is defined in section 172(c) as the amount by which a taxpayer’s business deductions exceed its gross income. The NOL rules originated in 1918 with the thought that the ability to carryforward or carryback an NOL (one year forward as well as one year back under the 1918 law) would correct for the artificial nature of a yearly closing of a business’s books based solely on income tax administrative purposes. Historically, the terms of the carryforward and carryback laws and regulations have varied wildly from no applicability during the early 1930s to the new law provision of zero carryback period with an indefinite carryforward of losses into the future until such time it is exhausted. In general, the 2017 law under section 172(b)(1) (A) stated an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.

While under prior tax law there was no general limit on an NOL amount of deductibility against taxable income, the amount of alternative minimum tax NOLs that could be used in a particular taxable year was generally limited to 90 percent of the alternative minimum taxable income for such year (subject to certain adjustments and exceptions). The TCJA eliminated the corporate alternative minimum tax for tax years beginning after Dec. 31, 2017.

The revised NOL deduction: The new law

The TCJA limits the NOL deduction to 80 percent of taxable income (determined without regard to the deduction) for losses arising in tax years beginning after Dec. 31, 2017. In addition, NOL carryovers to other years are adjusted to take into account this limitation, and may be carried forward indefinitely.

The provision repeals the two-year carryback and the special carryback provisions, but provides a two-year carryback in the case of certain losses incurred in the trade or business of farming.

The new law retains the present-law three-year carryback for the portion of the NOL for any taxable year which is a net disaster loss to which section 504(b) of the Disaster Tax Relief and Airport and Airway Extension Act of 2017 (Pub. L. No. 115–63) applies (i.e., a net disaster loss arising from hurricanes Harvey, Irma or Maria) and this is the case notwithstanding the repeal of the deduction for personal casualty losses under the TCJA.

The effective date of the provision allowing indefinite carryovers and modifying carrybacks generally applies to losses arising in taxable years beginning after Dec. 31, 2017. The provision limiting the NOL deduction applies to taxable years beginning after Dec. 31, 2017, and for losses incurred in taxable years beginning after Dec. 31, 2017. Therefore, for NOLs incurred in taxable years beginning before Jan. 1, 2018, and carried over to taxable years beginning after Dec. 31, 2017, the limitations and changes made to section 172 appear to not apply to such losses. As such, NOL carryover amounts generated in pre–2018 tax years should not be limited to the 80 percent of taxable income limitation in the new law.

As in prior law, pursuant to section 172(c), an NOL is defined to be the total of deductions under the Internal Revenue Code over the taxpayer’s total gross income.

So, based on the literal reading of the explanation of the changes to section 172 one may conclude the following:

1) In tax years beginning after Dec. 31, 2017, the use of an NOL is limited to only 80 percent of taxable income for losses which were generated in tax periods beginning after Dec. 31, 2017.

2) Pre–2018 NOL carryovers into 2018, appear not subject to the 80 percent of taxable income offset rule. This is the case since an NOL generated in tax years before the 2018 tax year, are not NOLs arising in tax years after Dec. 31, 2017.

3) For a taxpayer that generates an NOL in a tax year beginning after Dec. 31, 2017, that NOL may generally only be carried forward.
4) For a taxpayer that generates an NOL in 2018, that total loss may only be used to offset 80 percent of the 2018 taxable income, with the remainder unused NOL carried forward indefinitely to offset income in future years.

5) For a post-2017 NOL carried forward into a future year, only 80 percent of taxable income may be offset by that NOL tax attribute carryover.

6) For tax-exempt organizations structured as trusts, all of the above bullet points 1-5 may be further limited to a total allowable loss limitation (not addressed in this white paper analysis).

**Relationship of new section 172 with new section 512(a)(6): Unanswered questions**

Unanswered questions remain concerning the relationship of new section 172 with new section 512(a)(6). In particular, how are the suspended losses from separate trade or businesses, unusable due to the provisions of section 512(a)(6) treated for section 172 purposes? One thing is certain, the “suspended losses” that may not be used to offset other separate trade or business income arise in tax years beginning after Dec. 31, 2017.

The following issues are raised concerning the relationship of section 172 with section 512(a)(6):

1) Under the explanation of the new provisions as provided for in section 512(a)(6), suspended losses from a separate trade or business may be carried forward indefinitely to offset income from that specific separate trade or business income in future years, so how are these suspended losses characterized for tax purposes? Are they separate trade or business activity NOLs, or are they “suspended deductions” related to a separate trade or business?

2) If the answer to 1) is that the suspended losses are not NOLs, but “suspended deductions,” this explanation should mean that 100 percent of that future income generated from that specific trade or business may be offset by the suspended loss carryovers to that year.

3) If the answer to 1) is that the separate trade or business loss is an NOL, then the result appears to suggest that only 80 percent of future income from that separate trade or business activity may be offset with the suspended loss carryover which arose in a tax year beginning after Dec. 31, 2017 from that separate trade or business.

The explanation from the Joint Committee on Taxation (JCT) of section 512(a)(6) states that suspended losses under the provision may offset 100 percent of that specific separate trade or business income in a future period. However, the explanation then states that a net operating loss deduction is allowed only with respect to a trade or business from which the loss arose. This insinuates that the intention of this statute is to create a separate trade or business NOL. However, a few sentences later the explanation then provides that the intended result of section 512(a)(6) is that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year, but the provision generally does not prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate (with no mention of the term NOL).

In amended section 172 (post-TCJA changes), there is no carve out for separate activity trade or business NOLs which may be generated under the new rules that are provided in section 512(a)(6). However, the global definition of NOL remains unchanged in section 172(c), which clearly are considered the NOLs that are subject to the new rule (80 percent of taxable income rule).

Additional guidance must address all of the above open items.

**Conclusion**

Two new rules introduced into the Internal Revenue Code as a result of the TCJA, in one instance appear to not be interrelated, but in another appear completely interrelated in their applications.

Future guidance should clarify not only if suspended losses of a trade or business activity either does or does not rise to the level of NOL in order to adequately address the new section 172 limitation.
Until such time future guidance is issued, taxpayer advocate interpretations should apply as follows:

1) Separate trade or businesses are considered to include all activities in the same trade or business-like activity (e.g., all real estate rental activities are one trade or business; all passive investments generating unrelated business income are one trade or business of investing; all advertising receipts from whatever source is one trade or business). So the real estate trade or business is a separate trade or business from the investing trade or business and the advertising trade or business.

2) A separate trade or business loss that may not be used to offset other trade or business income in a tax year is carried over either as a separate trade or business NOL or as separate trade or business suspended deductions.

3) Whether or not defined as a separate trade or business NOL or separate trade or business suspended deduction, such loss will be used to offset 100 percent of future trade or business income specifically associated with the same separate trade or business to which the NOL or the suspended deductions arose, neither of which rise to the level of an NOL as defined in section 172, which must be limited to 80 percent of taxable income under the new rule.

4) Pre-2018 NOL carryovers to 2018 and future years, may offset 100 percent of unrelated business taxable income as determined under section 512(a)(6).

RSM will keep you abreast of future guidance related to the contents and analysis contained in this white paper as developments occur.
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