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UBI Will Now Be Separately Computed for Each Business Activity! What We Know, and What We're Waiting For

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Before the new tax law (P.L. 115-97) was enacted, exempt organizations could report their unrelated business activities and pay tax on unrelated business income ("UBI") on a net basis. They could combine their UBI amounts from all sources, deduct the related expenses, and pay any tax on the resulting net taxable income.

The new law, effective for tax years beginning after December 31, 2017, requires exempt organizations conducting more than one unrelated trade or business to calculate UBI separately for each unrelated trade or business. This practice effectively prohibits using losses arising from one specific unrelated trade or business to offset income from another unrelated trade or business. Also, exempt organization net operating losses ("NOL's") incurred after the effective date may only offset future income from that same trade or business – and are further limited on a percentage basis (as explained below).

As a result, many organizations may end up paying tax on UBI for the very first time, as they will no longer be allowed to net together income and losses arising from multiple unrelated business activities.

Unfortunately, the new law does not specify what makes up a separate unrelated trade or business. It's possible that IRS could take a practical approach, and group together business activities in broad categories, such as advertising, or debt-financed income. For example, should IRS define activities broadly, advertising from all of an organization's publications and from exploited exempt activities – such as from meetings and conferences – could be considered a single unrelated business activity and would be reported and taxed in the aggregate. Or, IRS could take a stricter approach and consider advertising from each publication, as well as from each meeting and conference, as separate unrelated business activities. In this event, the organization would need to compute UBI separately for each advertising activity, and pay tax on any activity that turns a profit (with no corresponding offset from activities generating losses).

And what about UBI from alternative investments? Calculating taxable UBI from partnership K-1's could become an arduous process, depending on what guidance IRS provides. Will it consider each investment K-1 to be a separate trade or business? Will partnerships have to provide K-1 details regarding each trade or business engaged in for exempt organizations to further parse UBI for each K-1 (truly a worst-case scenario)? Or will an organization be able to aggregate some or all of its UBI from alternative investments?

Furthermore, the new law is unclear on whether deductible expenses that are not specifically tied to a specific unrelated trade or business activity should be allocated. Examples include: state and local taxes, tax return preparation fees, and deductible charitable contributions. Will these expenses be allocated, or will they continue to be a general deduction toward taxable unrelated business income?

Further complicating matters are new rules on calculating and using NOL's. Under the new law, exempt organization NOL's incurred after the effective date not only are restricted to offsetting future income from the same separate unrelated trade or business, but are further limited to 80% of taxable income from that separate activity. Although the new law repeals the corporate alternative minimum tax (AMT), this new limitation on the use of NOL carryforwards essentially keeps one of the most common features of the AMT intact, and makes it stricter than before, by imposing an income limitation of 80%, as opposed to the old limitation of 90%.

NOL's generated before 2018 may offset all unrelated business income in 2018 and forward, regardless of the specific unrelated trade or business that created them. In addition, pre-2018 NOL's may be carried forward to future tax years without a percentage of income limitation, due to the repeal of the corporate AMT.

Interestingly, the new law treats taxable corporations and exempt organizations differently. Taxable corporations are not subject to this new regime of taxing different trade or business activities separately, and to limiting the use of NOLs to future income from the same trade or business activity. Organizations conducting multiple UBI activities, some of which generate income and some losses, might consider creating a taxable subsidiary corporation to house its UBI activities. The subsidiary would report all of the unrelated trade or business activities on Form 1120, instead of the exempt organization's reporting them on Form 990-T. The taxable subsidiary could then use losses from one business activity to offset income from another, just like exempt organizations could do before the tax law change. Any resulting tax would be computed on the net taxable income from these activities, as computed in the aggregate. Note, however, that NOLs that the exempt organization generated in earlier tax years cannot be transferred to a taxable subsidiary, so the taxable subsidiary cannot use such NOLs to offset any taxable income that the subsidiary generates in future tax years.

Additional guidance in this area is definitely needed to aid implementation of this new law. IRS recently updated its 2017-2018 Priority Guidance Plan to include this particular issue as a "near-term priority." With any luck, we will be seeing some guidance in this area in the near future. But in the meantime, we recommend that exempt organizations start taking a look at their UBI activities, and start making contingency plans for potentially adverse future guidance:

- Remember that NOL's in existence prior to January 1, 2018 may still be used against any net unrelated business income, *and* are not subject to the 80% limitation (though they still may be carried forward a maximum of 20 years). Accordingly, there may be an opportunity to utilize these losses against new or ramped-up existing unrelated business activities.
- Refine internal reporting *now* for all current UBI activities, so that in the event IRS defines "trade or business activity" narrowly, calculation of revenue and expense for separate UBI activities will be easier.
- Organizations that have considerable alternative investments generating UBI might wish to evaluate whether other investments that do not generate UBI might be a more practical alternative.

- As previously discussed, organizations with a mix of net income and net losses from several unrelated business activities might wish to explore whether formation of a taxable subsidiary would be advantageous, regardless of how IRS ends up defining “trade or business activity.”

We will provide additional information as more clarification and guidance becomes available.