July 2018 Newsletter

Unrelated Business Income Tax Under the Tax Cut and Jobs Act of 2017

Congress approved a conference report version of the nation's most sweeping tax law changes since the 1986 Tax Reform Act. Commonly called the Tax Cut and Jobs Act (the Act), the House, after the Senate passed a bill, re-voted this version on December 20, 2017. The measure was signed into law by the President on December 22, 2017. This legislation set record breaking marks for the appreciable size of numerous changes. All this transpired despite the nation's charities' position that the legislation "damages the civic infrastructure upon which our communities depend, and hurts the people that we serve."

While many changes were made to the non-profit landscape, this newsletter will focus on those changes that affect the calculation of unrelated trade or business income and the tax calculated. This newsletter will discuss the following items relating to unrelated trade or business income:

1. The unrelated trade or business bucket rule
2. The unrelated business income tax rate
3. The UBTI increase from certain fringe benefits.

Tax law has been clear that an activity not furthering the exempt purpose of the organization may be treated as unrelated trade or business. The organization determines the income and deductions from its unrelated trade or business and remits the appropriate tax on the resulting net taxable income. These axioms have been codified in Section 512 of the Internal Revenue Code. Prior to enactment of the legislation, a tax-exempt organization reported its activities in total, applied the exemption, and calculated the tax on the resulting income. If the activities produced an overall loss, the organization's tax liability would be zero. Also, the organization's overall loss would be carried forward as a net operating loss to future years.

Tax law has also provided both tax-exempt and taxable employers the ability to deduct expenses in computing taxable income. The allowance of deductions is normally allowed to the extent there are no statutory provisions preventing these deductions. One such statutory provision was Section 274. This statutory provision prevented or limited such deductions as meals and entertainment, social clubs, amusement and recreation facilities, unless the taxpayer substantiated a bona fide business reason or discussion that such expense was associated with the active conduct of a taxpayer's trade or business. Section 274 also added another onerous burden on the taxpayer to substantiate the deductions.

While Section 274 was restrictive in nature, Section 132 generally allowed a deduction to taxpayers who provided employees with fringe benefits. The fringe benefits in Section 132 provided an incentive to the employee because these benefits were not taxable to the employee. To cite examples, qualified transportation, parking, and on-premises athletic facilities are Section 132 employee fringe benefits. Therefore, the best of both worlds existed to each taxpayer (individuals and business) while jeopardizing the revenues of the federal government.

With this background in mind, the changes to the calculation of unrelated trade or business income have become less favorable. There are changes to both Section 512 and Section 274 that may increase the tax burden of a tax-exempt organization. The resulting changes were earlier categorized.

After the enactment of the Act, a tax-exempt organization must put its unrelated business income activities in separate buckets. Therefore, the result of these separate buckets is a loss in one bucket that can no longer offset the income from another bucket. Therefore, tax will be computed on each separate unrelated trade or business that produces net taxable income.

The tax law correlates the federal tax on UBTI to the basic federal income tax. The top rate of income tax imposed on corporations has been 35%. By reason of lowering the overall corporate tax rate to 21%, the corporate tax rate on UBTI is 21%. This provision took effect for tax years beginning after 2017.

The final topic to discuss relates to changes made to Sections 274 and 512. Section 274 received an additional disallowance for any qualified transportation fringe as defined under Section 132(f). This fringe relates to the cost of transit passes, qualified parking, or qualified bicycle commuting, and transportation in a commuter highway vehicle provided such transportation is used with travel between employee's residence and place of employment.

The Act has made changes to Section 512 by a similar provision. A new provision requires a tax-exempt organization to increase its unrelated business taxable income by an amount for which a deduction is not allowed under Section 274 and that is paid in connection with a qualified transportation fringe, a parking facility used in connection with qualified parking, or any on-premises athletic facility. This provision appears to be required even if the organization does not have an unrelated trade or business. This provision is intended to place tax-exempt organizations on a parity with taxable organizations for which expenditures are disallowed.

This parity also adds an additional burden on a tax-exempt organization to compute this unrelated business taxable income and remit a 21% tax on the amount paid or incurred for these fringe benefits. Nevertheless, this burden may be curtailed for many. The definition of an on-premises athletic facility is any gym or athletic facility that is located on the premises of the employer, operated by the employer and used substantially by all the employees of the employer, their spouses, and dependents. Therefore, schools, colleges, and universities can avoid this additional burden because athletic students and students participating in intramural activities will constitute most of the use. The Code also does not provide meaning for the word gym or facility. A home gym may constitute a treadmill, stationary bike, an abdominal lounge and some weight lifting equipment. If a tax-exempt employer puts these items in an area, will that constitute a gym for purposes of this new measure? Guidance is likely necessary to determine the end result.

The statutory language does not imply value of these benefits provided. Thus, if a tax-exempt organization provides these benefits at no cost, the organization intuitively does not have any tax liability under this new provision. So those organizations, that provide tax-free parking, should not be affected by this provision.

The major group of tax-exempt organizations affected by this provision are those that pay employees for their qualified transportation to and from work and provide assistance with parking. The new law appears to keep intact the employer's right to exclude these benefits as income from the employer. The new law attempts to level the playing field by denying a deduction to taxable employers and increase unrelated trade or business income to a tax-exempt organization.

While many questions will continue to rise on this matter, future guidance is required for tax-exempt organizations to comply. The provision requires regulations to be promulgated by the Internal Revenue Service to provide guidance on this new provision. The regulations may also include appropriate deductions for depreciation and utilities. However, with the Service facing severe budget cuts and difficulty in customer service, regulations may not be forthcoming in the near future.

Should you have any questions regarding this newsletter, please contact us.

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