

Tax Reform Could Change Taxable Income for Colleges and Universities

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One area of tax law changed by the Tax Cuts and Jobs Act (“Act”) which may affect higher education institutions of different sizes is the area of Unrelated Business Taxable Income (UBTI). UBTI is calculated on the gross income derived by a tax-exempt organization from any unrelated trade or business regularly carried on by the organization, less allowable deductions. Tax-exempt organizations generate unrelated business income if it is not substantially related to the organization’s exempt purposes. A net operating loss (“NOL”) is allowed in the computation of unrelated taxable business income. Prior to the Act, all unrelated activities could be combined and losses in one could be used to offset gains in another.

Under the Act, an organization that has one or more unrelated trade or business activities will compute UBTI separately for each activity. This means that losses from one unrelated trade or business may not be used to offset the income derived from another unrelated trade or business. Thus, profits and losses must be calculated and applied separately, subject to an exception for certain NOLs arising from a tax year beginning prior to 1/1/2018. This will require nonprofit organizations to account for each trade or business separately, which may increase the administration of these types of activities and it may also adversely affect the annual tax liability. To partially offset these additional tax burdens, a transition rule was adopted that permits pre-2018 NOLs to be used against UBTI in subsequent years. The Act also reduced the corporate income tax rate to 21 percent. Organizations with multiple unrelated trades or businesses may want to restructure these activities and consider moving these activities to a taxable subsidiary after careful examination of all potential resulting tax and other effects. An example may be helpful.

College A has two unrelated activities, Activity 1 and Activity 2. Certain supporting administrative functions were shared by the two activities. Prior to the Act, College A simply aggregated all of the income and expenses for the two activities and calculated the net income or NOL for UBTI purposes. In this example, Activity 1 typically generated \$100,000 in net income and Activity 2 typically generated a \$100,000 net loss. Since the two activities could be aggregated, College A’s net income was \$0 and therefore resulted in no UBTI liability. Under the Act, College A will be required to account for the profits and losses of each activity separately. This means that the shared administrative or indirect costs must be allocated between the two activities which will require a more detailed accounting process. Although this creates an administrative burden, the real negative impact comes with the inability to combine Activity 1’s profit with Activity 2’s loss. In this example, tax will be paid on the net income of \$100,000 for Activity 1. The \$100,000 net loss for Activity 2 will simply result in a \$0 tax liability for that activity. The end result will be that College A will now have a \$100,000 taxable income for UBTI purposes, compared to \$0 in the past.

Commentators suggest that the logic behind this change is based on the concept that an organization would not conduct an activity that normally generates a loss unless it furthers the organization’s mission. Otherwise, why would an institution engage in an activity not related to its mission unless that activity generates a profit? Given the effect of the Act, it would be prudent to re-evaluate how your mission aligns with unrelated activities that are generating a loss.



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Additionally, providing certain employee fringe benefits under section 274 may trigger UBTI. Some employee fringe benefit expenses that were previously deductible by for-profit employers are no longer deductible and may trigger UBTI if provided by a tax-exempt employer. These disallowed fringe benefits include any nondeductible entertainment expenses, and costs incurred for any qualified transportation, a parking facility used in connection with qualified parking, or any on-premises athletic facility. However, UBTI does not include any such amount to the extent it is directly connected with an unrelated trade or business regularly carried on by the organization. These fringe benefits continue to be excludable by the employees receiving such benefits.

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