

Ambiguity May Let Nonprofits Sidestep 'Siloing' Of Tax Losses

By Amy Lee Rosen

Law360 (May 4, 2020, 8:13 PM EDT) -- Ambiguities surrounding how a recently passed COVID-19 relief law expanding net operating loss carrybacks interacts with nonprofits' unrelated business taxable income could temporarily allow tax-exempt organizations to use losses to offset income under a separate so-called silo.

Congress in March passed the Coronavirus Aid, Relief and Economic Security Act, which repealed an 80% income limitation on net operating losses and allowed NOLs to be carried back for up to five years to generate an immediate tax refund. Then last month the Internal Revenue Service issued proposed regulations on the grouping of nonprofits' profits and losses from related business activities to institute a change under the 2017 Tax Cuts and Jobs Act requiring nonprofits to separately calculate taxable income streams, or silos.

Being allowed again to carry back net operating losses for five years may present a unique opportunity for nonprofits, according to Alexander Reid, a tax partner at Morgan Lewis & Bockius LLP.

While the TCJA requires nonprofits to separately silo and track unrelated business taxable income and pay applicable taxes, now an organization can potentially generate losses, carry them back to nonsiloed tax years, grandfather those losses and then apply them to future nonsiloed profits, he said.

"It was complicated to begin with, but now it's an infinite loop," Reid said. "You earn a loss in a silo, you carry it back to a tax year before the silo rules, and then you carry it forward to any silo in the future."

Before Congress passed the CARES Act, many practitioners had already asked the IRS for clarity on the interaction between net operating losses and unrelated business taxable income, or UBTI, according to Elinor Ramey, a tax partner at Steptoe & Johnson LLP. She was a policy adviser and attorney at the U.S. Department of the Treasury's Office of Tax Policy until February.

Under changes made to Internal Revenue Code Section 512(a)(6) by the TCJA, tax-exempt organizations that have two or more regularly carried-on unrelated trades or businesses have to calculate income and



The IRS has proposed rules that provide some relief to nonprofits to comply with a change in the TCJA that required nonprofits with more than one taxable side operation to separately calculate unrelated business taxable income for each such business. (AP)

losses associated with each one separately under Section 511 of the code. The income is typically taxed at the corporate income tax rate, 21%.

Before the 2017 tax overhaul law was enacted, NOLs could be carried back for up to two years or carried forward at a rate of 100%, but only for up to 20 years. After the TCJA, however, companies could no longer carry back NOLs in tax years after 2017, but could carry forward NOLs indefinitely at 80%.

Because the siloing rules did not apply before 2018, it was unclear how nonsiloed-year losses could be carried forward to years when siloing was required, Ramey said. Practitioners also wanted the IRS to specify how to deal with post-2017 NOLs that were tied to a business that had to be siloed, she told Law360.

But now under the CARES Act, NOLs arising in 2018, 2019 and 2020 can be carried back for up to five taxable years and carried forward to future years without the 80% limitation, she said. The change to NOLs makes figuring out how they work in conjunction with the UBTI siloing rules even more complicated, she said.

"The proposed rules don't address it," Ramey told Law360.

The government will consider how the NOL provision under IRC Section 172 affects calculating UBTI and may issue additional guidance, according to the proposed rules.

Reid told Law360 his understanding is that NOLs can potentially be carried back to nonsiloed years and carried forward because of one way of reading the ordering provision included in the proposed rules.

Nonprofits with more than one unrelated trade or business after 2017 must separately calculate losses with respect to each trade or business and apply NOLs separately for each separate trade business, according to the proposed rules. But if an organization has pre-2018 NOLs generated when siloing was not required, then in siloed years the nonprofit first deducts the pre-2018 NOLs from the total amount of UBTI before deducting post-2017 NOLs from its separate trades or businesses, the regulations said.

Section 13702(b)(2) of the TCJA added a grandfather rule to Section 512 such that any losses generated by a nonprofit's taxable business during nonsiloed years can be applied to post-2018 years against total UBTI instead of against the profits from one silo, Reid said.

So theoretically nonprofits' losses can now be carried back to a nonsiloed year and then carried forward and applied to total UBTI in future years, Reid said. However, there is some regulatory risk associated with this strategy, since it's unknown if the government would support it, he said.

Douglas Mancino, a tax partner at Seyfarth Shaw LLP, told Law360 he thought it was still unclear whether nonprofits can carry back losses to a nonsiloed year and then carry NOLs forward without siloing restrictions to years that require tracking of separate revenue streams from unrelated trades or businesses.

What is clearer, however, is that it's likely if a NOL generated in 2020 is applied back to 2019 or 2018, or a 2019 NOL is carried back to 2018, when siloing is still required, a nonprofit would probably have to offset the 2020 losses against the specific business' profits from a siloed year, he said.

That would likely be consistent with congressional intent because a nonprofit could still carry back NOLs, as now allowed under the CARES Act, but would still have to track losses and profits from unrelated trades and businesses, which is consistent with what Congress wanted in the TCJA, Mancino said.

Nevertheless, it may just be best to wait for guidance from the IRS, since it's still unclear what one can do if a nonprofit carries back siloed losses to pre-siloed years, he said.

Amanda H. Nussbaum, a tax partner at Proskauer Rose LLP, told Law360 nonprofits need to compare the worth of NOLs generated now with those from before the TCJA because of changes to corporate tax rates. Being able to apply the losses to years before the TCJA was enacted would be more beneficial than applying them to tax bills now because before 2018, a company had to pay 35% taxes on its income, whereas now the corporate tax rate is only 21%, Nussbaum said.

"The carryback is valuable for tax-exempt organizations that are taxed at the corporate rate because of the higher corporate tax rate that applied prior to 2018," Nussbaum said.

But it would be harder to successfully argue that one can carry back losses and grandfather them, because that would seem to magically convert losses, she said.

"Treasury would need to come out with something affirmative in the regs that would permit you to use losses that were generated post-2017 to post-2017 years in a way that permits you to use them without the impacting of the siloing rule," Nussbaum said. "It's something they realize they need more time to figure out."

--Editing by Tim Ruel and John Oudens.