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Net Operating Loss Rules

Because of the 2017 Tax Cuts and Jobs Act (TCJA) and the recent Coronavirus Aid, Relief, and Economic Security (CARES) Act, the rules for an exempt organization's (EO) use of a net operating loss (NOL) incurred in an unrelated business activity have become complex.

Pre-TCJA Rules

An NOL arising in a tax year beginning before January 1, 2018, generally could be carried back two years and forward for up to 20 years after the loss year [IRC Sec. 172(b)(1)(A) and (F)]. This NOL is (or was) allowed as a deduction in computing unrelated business taxable income (UBTI) in the year or years to which it is (or was) carried, up to 100% of the EO's unrelated business income. The deduction is (or was) allowable against any UBTI.

Post-TCJA Rules

TCJA made three changes to an EO's NOL:

- For tax years beginning after December 31, 2017, an EO with more than one unrelated trade or business (UTB) must calculate UBTI separately for each one. A loss from one UTB cannot offset income from a different UTB. Consequently, NOLs that originated in tax years beginning before January 1, 2018, must be tracked separately from those that originate(d) in tax years beginning after December 31, 2017.
- An NOL cannot be carried back two years as before, but can be carried forward indefinitely.
- An NOL for tax years beginning after December 31, 2017, can be used to offset only 80% of taxable income in a carryforward year [IRC Sec. 172(a)(2)].

CARES Act Modifications

An NOL arising in a tax year beginning in 2018, 2019, or 2020 can be carried back five tax years. For an NOL carryforward in tax years beginning before 2021, an EO will be allowed an NOL deduction equal to 100% (rather than being limited to 80%) of taxable income. In tax years beginning after 2020, an EO will be allowed to offset up to 100% of UBTI for an NOL arising in tax years beginning before 2018 and up to 80% of modified taxable income for an NOL arising in tax years beginning after 2017.

In this Issue:

An EO cannot choose which of the five prior years to carry a loss to achieve the largest refund. Rather, an NOL carryback must be carried to the fifth preceding tax year and then, to the extent not fully used, brought forward to the fourth and subsequent preceding tax years.

There is no form used to carry back a loss. An EO simply amends the Form 990-T previously filed for the carryback year. To expedite processing of the amended return, the authors recommend writing "Amended Return CARES Act NOL Carryback" at the top of page 1 of Form 990-T. Attach a statement indicating the NOL year.

Example: If an EO had a loss in tax year 2018 that it is carrying back to tax year 2013, complete Parts I and II of the 2013 Form 990-T as originally done, down to Part II, line 31, "Net operating loss deduction." Enter the carryback on line 31, up to 100% of the UBTI shown on line 30. Complete the rest of the Form 990-T based on the line 31 entry. Include on the "other" sub-line of line 44g ("Other credits and payments") the tax shown on line 47 ("Tax due") of the return as originally filed or previously amended.

Order of Use

An EO with both pre-2018 and post-2017 NOLs deducts its pre-2018 NOLs from its total UBTI under IRC Sec. 512(a)(6)(B) before deducting any post-2017 NOLs for a separate unrelated business from the UBTI of that business. Therefore, pre-2018 NOLs are deducted from total UBTI in the manner that results in maximum use of the pre-2018 NOLs in a tax year [Prop. Reg. 1.512(a)-(6)(h)].

Practical Consideration:

Attach a statement to a Form 990-T amended for an NOL carryback showing how it is calculated when (1) the NOL is used in more than one carryback year because it could not be fully used in the initial carryback year, or (2) the NOL is carried through tax years for which a Form 990-T was not required.

Proposed Regulations for Multiple Unrelated Trades or Businesses

Background

Prior to the enactment of IRC Sec. 512(a)(6) in the Tax Cuts and Jobs Act (TCJA), an exempt organization (EO) with gross income from the regular conduct of two or more unrelated trades or businesses calculated unrelated business taxable income (UBTI) by aggregating the gross income from all activities and deducting the aggregate allowable deductions.

TCJA changed this calculation so that, in the case of any EO with multiple unrelated businesses:

- UBTI, including the determination of any net operating loss (NOL) deduction, must be computed separately for each business, without regard to the $1,000 specific deduction;
- UBTI is the sum of the unrelated business income (UBI) for each business, less the $1,000 specific deduction; and
- the UBI for any business cannot be less than zero (i.e., it cannot be a loss).

New Guidance

TCJA did not provide explicit criteria for determining whether an EO has more than one unrelated business. Notice 2018-67 (2018-36 IRB 409) provided interim guidance and transition rules concerning IRC Sec. 512(a)(6). Recently released proposed regulations modify and expand the guidance contained in Notice 2018-67. The proposed regulations are not effective until tax years beginning or after the date the regulations are published as final. But, until then, EOs can rely on them in their entirety. Alternately, until they are published as final, an EO may choose to rely on Notice 2018-67 for aggregating or identifying separate trades or businesses.

Trade or Business—An Overview

There is no general statutory or regulatory definition of what is considered a *trade or business* for income tax purposes. Whether an activity is a trade or business varies depending on the Code section involved.

Notice 2018-67 permitted a reasonable, good-faith interpretation of IRC Secs. 511–514, considering all the facts and circumstances, in determining whether an EO has more than one business for Section 512(a)(6) purposes.

The Classification System

Notice 2018-67 provided that a reasonable, good faith interpretation should include the use of the six-digit North American Industry Classification System (NAICS) codes in determining whether there is more than one business. Basically, NAICS divides the economy into 20 sectors. The first two digits of the code designate the sector, each of which represents a general category of economic activity. Each of the remaining four digits describes an industry with increasing specificity.

Treasury and the IRS have decided that the using the full six-digit coding would be too burdensome because of their specificity, and could potentially require an EO to divide what may have traditionally been considered one unrelated business into multiple businesses. Consequently, the proposed regulations provide that an EO can generally identify its separate unrelated businesses using only the first two digits of the NAICS codes [Prop. Reg. 1.512(a)-(6)(b)(1)]. The rationale behind this conclusion is that the broad scope of activities described by the first two digits should cover all unrelated business activities of EOs, making it more likely that EOs engaged in similar activities that could be described in more than one NAICS six-digit code will report them as part of the same business rather than multiple businesses.

Note: The NAICS classification system is available at **www.census.gov/eos/www/naics/**.

Code Selection—Choose Wisely

The proposed regulations caution that the two-digit code chosen must identify the unrelated business in which the EO is engaged (directly or indirectly) and not the activities the conduct of which are substantially related to the exercise or performance by such EO of its exempt purpose(s). Once an EO has identified a separate unrelated business using a particular NAICS two-digit code, it may not change it for that business unless it can show that the code chosen was due to an unintentional error and that another two-digit code better describes the business [Prop. Reg. 1.512(a)-(6)(b)(3)]. This restriction will apply to codes reported on the first Form 990-T filed after final regulations under IRC Sec. 512(a)(6) are published. Form 990-T instructions will describe how an EO provides notification of such an error.

Multiple Locations

An EO may have a business that operates in different geographical areas. For example, a hospital organization may operate several facilities in an area (or multiple geographical areas), all of which include pharmacies that sell drugs to the general public (i.e., an unrelated business). Pharmacies are described under the NAICS code for retail and trade (44). Although each pharmacy potentially could be considered a separate business under IRC Sec. 512(a)(6), especially if separate books and records are kept for each location, the proposed regulations provide that an EO will report each NAICS two-digit code only once [Prop. Reg. 1.512(a)-(6)(b)(2)]. Consequently, in this example, the hospital organization would report all its pharmacies using the retail trade code 44, along with any other retail businesses as one unrelated business on Form 990-T.

Expense Allocation—Interim Rules

EOs often incur expenses (e.g., compensation, rent, tax return preparation fees, and depreciation) that are attributed to the conduct of both exempt and unrelated business activities. These joint expenses must be allocated between the two activities on a reasonable basis [Reg. 1.512(a)-1(c)]. The requirement that an EO with multiple unrelated businesses calculates the net income of each one separately potentially adds another layer of complexity to the allocation process since the EO must not only allocate indirect expenses between exempt and unrelated business activities but also to each separate unrelated business. Under these circumstances, Treasury and IRS are concerned that permitting allocation methods solely on *reasonableness* would be difficult for the IRS to administer and perhaps not provide certainty for EOs. Consequently, Treasury and the IRS intend to publish a separate notice of proposed rulemaking providing guidance on this issue. Until then, EOs can continue to allocate shared expenses on a reasonable basis.

The preamble to the proposed regulations does not elaborate upon the meaning of reasonable except to state that the *unadjusted gross-to-gross method* of allocation is not a reasonable method. This method allocates shared expenses between exempt activities and unrelated business activities using the ratio of revenue from each to total revenue. This skews the allocation of expenses in favor of an unrelated activity when an EO charges a higher price for goods or services in an unrelated activity than in a related activity (e.g., where a school that operates a ski facility charges the public more for ski lift fees than it charges its students). However, the gross-to-gross method is acceptable for now if the "per unit" price of goods or services is *adjusted* to reflect the charge differential between related and unrelated activities.

Investment Activities

Some investment activities can be unrelated businesses. These include, among other things, investments in partnerships, S corporation, stock, and debt-financed property. The proposed regulations provide extensive details to determine when an investment is a separate business. Since the NAICS codes are for the identifying businesses, there are no two-digit codes to identify investment activities. The IRS intends to modify Form 990-T and related schedules and the instructions to accommodate the identification of investments as separate businesses.

Standard Setters Defer Standards in Response to COVID-19 Challenges

FASB

Deferred Effective Dates

To address challenges relating to the coronavirus pandemic, on April 21, 2020, the FASB issued a proposed one-year deferral for the effective dates of FASB ASC 606, *Revenue from Contracts with Customers,* and FASB ASC 842, *Leases*. Early adoption is still permitted.

The FASB ASC 606 deferral applies to nonpublic franchisors and thus generally isn't applicable for nonprofit organizations.

The FASB ASC 842 deferral changes the effective date by one year for most nonprofit organizations to fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. This would make it applicable for nonprofit organizations with fiscal years ending December 31, 2022, or June 30, 2023. For public nonprofit organizations (issuers or conduit bond obligors of publicly traded securities) that have not yet issued financial statements, the effective date is deferred to fiscal years beginning after December 15, 2019, including interim periods within those years.

The FASB's proposed ASU has a 15-day comment period. We believe a final ASU will be issued soon after the comment period closes to officially delay these effective dates.

Lease Concessions

The FASB staff issued interpretative guidance on April 10, 2020, on accounting for lease concessions made as a result of the coronavirus pandemic. Economic challenges from COVID-19 are resulting in lessors providing lease concessions to their tenants in significant numbers.

The guidance is in the form of a Question and Answer document. In it, the FASB indicates lessors may elect whether to apply FASB ASC 842 (or FASB ASC 840) lease modification guidance for concessions they are granting to lessees. They can elect to account for concessions as though enforceable rights and obligations exist, without being required to analyze each lease contract to make this determination. The Q&A offers two methods of accounting for the concessions—

- increasing the lease receivables and payables as payments accrue and recognizing lease income and expense during the deferral period, or
- accounting for deferred payments as variable lease payments.

The election is available if the concessions don't result in a substantial increase in lessor rights or lessee obligations, which will be a matter of judgment. For example, the election is available if the total lease payments due under the modified lease are less than, or substantially the same as, those due under the original lease.

Under FASB ASC 842, a lease modification is a change in the terms of a contract that results in a change in the scope of, or the consideration for, a lease. Under existing lease accounting guidance, if lessors grant concessions resulting in changes to lease payments not provided for in the original lease, those concessions are generally accounted for as lease modifications. A modification may be accounted for as a modified lease, with the lessee and lessor reconsidering the lease's classification and the measurement of the lease asset and liability, or as two leases—the original one and a new one. Concessions aren't accounted for as lease modifications if the lease contract includes explicit or implicit enforceable rights and obligations when certain circumstances out of the control of the parties to the lease arise, and no changes are made to the lease.

The Q&A indicates that entities may choose to continue to apply existing modification guidance in accounting for lease concessions related to COVID-19. In addition, all such concessions aren't required to be accounted for the same way, although FASB ASC 842 and FASB ASC 840 should be applied consistently to leases in similar circumstances and those that have similar characteristics. Both lessors and lessees should disclose any material lease concessions granted or received and how they were accounted for.

The FASB staff developed this Q&A in response to concerns and questions they have received, and they intend to issue additional guidance to address new implementation issues arising from COVID-19.

Practical Consideration:

The Q&A is available on the FASB's website at **www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176174459740&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay**.

AICPA Auditing Standards Board

The following Statements on Auditing Standards (SAS) issued in 2019 and 2020 have effective dates for audits of financial statements for periods ending on or after December 15, 2020:

- No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements,* as amended.
- No. 135, *Omnibus Statement on Auditing Standards—2019.*
- No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA,* as amended.
- No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports.*
- No. 138, *Amendments to the Description of the Concept of Materiality.*
- No. 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134.*
- No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137.*

SAS Nos. 134, 136, 137, 139, and 140 do not permit early implementation.

Because of the auditing and accounting challenges related to COVID-19 smaller and midsize firms are facing, the ASB voted to defer the effective dates of SAS Nos. 134–140 from periods ending on or after December 15, 2020, to periods ending on or after December 15, 2021 (one year delay), and allow for early implementation.

Practical Consideration:

More information related to these auditing standards and how these delays impact *PPC's Guide to Audits of Nonprofit Organizations* is available at **thomsonreuterstaxsupport.force.com/pkb/pkb_Home?c=Products_Support%3APPC_s_A_A_wProducts&h=PPC%27s%20A%26A%20Products**.

AICPA Professional Ethics Executive Committee (PEEC)

On May 5, 2020, PEEC will meet to discuss the AICPA Professional Ethics Division staff's recommendation to defer the effective dates of the following AICPA ethics interpretations by one year:

- ET 1.295.145, *Information System Services,* currently effective January 1, 2021.
- ET 1.224.020, *State and Local Government Client Affiliates,* currently effective for fiscal years beginning after December 15, 2020.
- ET 1.260.040, *Leases,* currently effective for fiscal years beginning after December 15, 2019.

These three interpretations currently allow for early implementation, and the staff is recommending to PEEC that early implementation continue to be allowed.

Effect of Deferral of Standards on NPO Audit Guide

As discussed in the preceding article of this issue of *The PPC Nonprofit Update,* in April 2020, the Auditing Standards Board issued SAS 141, *Amendment to the Effective Dates of SAS Nos. 134–140,* to defer the effective dates of these SASs for one year, and the FASB has proposed a one-year deferral for the effective dates of ASC 842, *Leases,* with early adoption still permitted. Because the 2020 edition of *PPC's Guide to Audits of Nonprofit Organizations* (NPO or *Guide*) was issued prior to the deferral of these standards, we want to update you on how those deferrals affect the *Guide.*

New Standards and Effect on NPO

The audit programs, checklists, letters, other practice aids, and practical guidance in the *Guide* have been updated throughout to incorporate SAS 135. Early adoption was originally permitted for SAS 135. Changes made include:

- Revising the procedures for testing significant unusual transactions and related-party relationships and transactions, including new procedures for testing previously undisclosed related parties, if applicable, in the General Auditing and Completion Audit Program (AP-2).
- Adding practical considerations throughout the practice aids highlighting relevant changes in the standards.
- Updating guidance as applicable in the chapter discussions.

We believe that the changes made to incorporate SAS 135 improve audit quality without significantly changing the auditor's overall workload and, therefore, we believe that early implementation of SAS 135 is a best practice.

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The audit programs, checklists, letters, other practice aids, and practical guidance have been updated to provide dual guidance for changes for SAS 134 and SAS 137, as well as SAS 138. This dual guidance is provided primarily in practical considerations and instructions throughout the practice aids, as well as in applicable chapter text. In addition to dual guidance, we have also provided a new illustrative engagement letter (CL-1.1.2) and numerous auditor's report illustrations (Appendix 13F and 13G series) that incorporate the changes resulting from these standards for use once those SASs have been adopted.

Because SAS 139 and 140 were not yet issued as of the date of the *Guide,* the primary provisions of the exposure drafts were incorporated into the chapter discussions, as applicable, but updated practice aids were not provided.

The audit programs, checklists, letters, and other practice aids in the *Guide* continue to provide dual guidance for FASB ASC 842 that continues to be available. The dual guidance is provided with alternative audit program steps and disclosure steps for FASB ASC 842. We also provide a confirmation of lease contracts under FASB ASC 842 (CL-12.3.2).

Update on Yellow Book and Single Audit Reports

The reports in Appendix 13D (2011 Yellow Book reports on internal control and compliance) may be used for periods ending before June 30, 2020. The notes to the reports in Appendixes 13A-3, 13D, and 13E, and at Appendixes 13F-3, 11H, and 13I indicate that the AICPA Audit Guide, *Government Auditing Standards and Single Audits,* is expected to be released in early summer 2020, and include updated report illustrations. That guide is now expected to be released in July or August 2020 without revised reports on the financial statements and supplemental schedule of expenditures of federal awards for use in a single audit, Yellow Book reports, or single audit reports illustrating the new reporting SASs. However, the guide will include revised Yellow Book reports addressing the 2018 Yellow Book and certain other changes. A limited number of reports illustrating the new reporting SASs are expected to be releasedthrough the AICPA Government Audit Quality Center website in the fall of 2020.

Practical Consideration:

Remember that the 2018 Yellow Book is effective for financial audits of financial statements for periods ending on or after June 30, 2020, with early implementation not allowed. The effective date of the Yellow Book is *not* being deferred. The 2020 edition of NPO includes dual guidance for audits conducted under either the 2011 or 2018 Yellow Book. Report illustrations reflecting changes necessary due to implementation of the 2018 Yellow Book will be released as indicated in the respective appendixes.