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Nonprofits and Tax-Exempt Organizations

ALERT

APRIL 2020

IRS and Treasury Issue Proposed UBTI "Silo" Regulations

The U.S. Department of the Treasury and the Internal Revenue Service published proposed regulations (REG-106864-18) April 23 that provide much-needed guidance on the rules for calculating unrelated business taxable income (UBTI) under Section 512(a)(6). The Proposed Regulations clarify and build on the interim guidance provided in IRS Notice 2018-67 issued in August 2018, and incorporate feedback from numerous comments on the Notice. Exempt organizations with more than one unrelated trade or business, and especially those with any sort of investment income, should be aware of the changes made by the Proposed Regulations in calculating UBTI.

Section 512(a)(6) was introduced in 2017 as part of the Tax Cuts and Jobs Act (TCJA). Prior to the TCJA, an exempt organization calculated UBTI and any related deductions on an aggregate basis with respect to any and all unrelated trades or businesses conducted by the organization. Section 512(a)(6) introduced the concept of "silos" of UBTI. Exempt organizations could no longer calculate UBTI on an aggregate basis, but instead were required to calculate UBTI (and any related deductions) separately for each unrelated trade or business run by an organization. This new silo rule prevents organizations from using losses from one unrelated trade or business to offset income from a different unrelated trade or business. Despite the silo requirement for UBTI calculations under Section 512(a)(6), Congress did not provide explicit criteria for determining whether an exempt organization has "more than one unrelated trade or business" or how to identify "separate" unrelated trades or businesses. The Proposed Regulations respond to both of these questions.

Exempt organizations, individual retirement plans (IRAs) described in Section 408(e) and employee plans with UBTI should review the new Proposed Regulations closely, as they apply to all of these types of entities. Comments on the Proposed Regulations are due by June 23.

Separate Unrelated Trade or Business

The Proposed Regulations offer new rules for determining when an organization has separate, unrelated trades or businesses. Overall, these new rules are more concrete than the reasonableness/facts and circumstances standard provided in the Notice and improve the administrability of the UBTI silo requirement both for taxpayers and the IRS.

Two-Digit NAICS Codes

The Proposed Regulations use North American Industry Classification System (NAICS) codes as the primary methodology for identifying separate trade or business activities. This industry classification system uses a combination of up to six digits to categorize certain economic activities. In a significant improvement over the Notice, the Proposed Regulations allow separate trades or businesses to be identified solely by two-digit, rather than six-digit, NAICS codes. This change reduces the number of potential trade or business categories to (currently) 20—a significantly reduced administrative burden on nonprofit organizations. Two-digit NAICS codes are inherently broader than the six-digit codes, encompassing and aggregating more activities into a single category of UBTI. For example, under the Proposed Regulations, a college or university may include all unrelated "real estate, rental, and leasing" income under one unrelated trade or business category, rather than having to break down this category even further into, for example, residential leases, commercial leases, property management and equipment rental. The Proposed Regulations are clear that an organization must use the NAICS code that identifies the unrelated trade or business and not the code that describes the organization's general activities (i.e., the college would not cite the NAICS code for "educational activities" in this UBTI reporting context).

The Proposed Regulations explicitly note that a NAICS code may be listed only once for an organization, even if that exempt organization internally manages the same type of income-generating activity in several different geographic locations. The Proposed Regulations specifically include the example of a hospital organization that may operate several hospital facilities in multiple geographic areas, all of which include pharmacies that sell goods to the general public. Under the Proposed Regulations, the NAICS code for the pharmacies (44) should be listed only once for the organization, even if the hospital organization keeps separate books and records for the various pharmacies.

Investment Income

Although the Proposed Regulations allow exempt organizations to generally determine their separate categories of UBTI by the two-digit NAICS codes, there are some exceptions, including a category referred to as "investment income." The Proposed Regulations allow organizations to aggregate certain investment activities and treat them as a single unrelated trade or business. This follows the approach taken in the Notice, but the Proposed Regulations provide more comprehensive guidance on which activities constitute investment activities, including a specific list of activities that may be included and some that should not be. Under Prop. Reg. Sec. 1.512(a)-6(c)(1), all debt-financed income, qualifying partnership interests and qualifying S corporation interests are included as "investment activities," but controlled entities under Section 512(b)(13) and controlled foreign corporations under Section 512(b)(17) are explicitly not included. As a result, each of an organization's controlled for-profit entities, as described in Section 512(b)(13), is treated as having its own separate unrelated trade or business, and unrelated business income from these entities is not aggregated with other investment activities or with other subsidiaries.

As noted above, qualifying partnership interests (QIPs) are included in the UBTI category of an organization's "investment activities." QIPs include partnership interests that meet either a de minimis test or a control test. The de minimis test is met when the organization holds directly no more than 2% of the profits interest and no more than 2% of the capital interest of a partnership. The control test is met if the organization holds no more than 20% of the capital interest and does not control the partnership. Control is based on facts and circumstances, but the Proposed Regulations also note four factors that will be considered evidence of control. Importantly, the Proposed Regulations do not require an organization to aggregate related partnership interests in determining the de minimis test, and do not require that partnership interest held by disqualified persons be included in determining the control test.

Special Provisions

The Proposed Regulations include a number of special provisions that are important to highlight, as Treasury and the IRS have specifically asked for additional comments on these provisions.

Expense Allocation

The Proposed Regulations currently allow exempt organizations to use any reasonable method to determine an appropriate allocation of expenses among different categories of UBTI, as well as between exempt and nonexempt activities, with one explicit caveat. If the exempt organization offers the same income-generating activity to different groups of people (say, members and nonmembers) at different prices, the organization's allocation method must make adjustments for the price differences. The Proposed Regulations are clear that the "unadjusted gross-to-gross" method of expense allocation is not a reasonable method, as it would give the organization too much discretion to change prices and reallocate expenses accordingly.

Net Operating Losses (NOLs)

As noted above, under these new UBTI silo rules, an organization cannot offset income from one unrelated trade or business with losses from a separate unrelated trade or business. It can, however, use NOLs to offset against its aggregate UBTI, depending on when the NOLs were generated. NOLs that were generated before 2018 that are not tied to a specific unrelated trade or business may be applied against the aggregate total of an organization's UBTI. These pre-2018 NOLs should be used before any others generated since 2017. NOLs generated after 2017 that are connected to a specific unrelated trade or business may be used after that, but only against UBTI for each separate trade or business.

We expect these rules to be further clarified, as they do not account for recent changes to the NOL provisions under Section 172. The TCJA in 2017 limited the NOL deduction to 80 percent of taxable income, and prohibited carrybacks of any NOLs, but allowed the carry forward of NOLs indefinitely. The Coronavirus Aid, Relief, and Economic Security (CARES) Act, however, temporarily repealed the 80% income limitation and permits the carryback of NOLs arising in taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2021, to each of the five taxable years preceding the taxable year of such loss. Treasury and the IRS must consider how these changes under the CARES Act impact the UBTI silo rules.

Other Organizations

Identification of separate trades or businesses for entities described in Section 512(a)(3) will be governed by separate rules. Social clubs, voluntary employee benefit associations and supplemental unemployment compensation benefits trusts with potential UBTI should consult with their tax advisors. As noted above, IRAs are also subject to these rules in the Proposed Regulations.

Comments

In our view, the Proposed Regulations provide a workable response to the open-ended congressional mandate provided by Section 512(a)(6). Although the Proposed Regulations respond to many of the inherent questions under Section 512(a)(6), exempt organizations still have an important opportunity to provide comments by June 23. We have seen a significant and thoughtful response in these Proposed Regulations to taxpayers' comments on the Notice, and we look forward to helping prepare comments for interested clients to help Treasury and the IRS further refine these rules in the final UBTI regulations..

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6315 REV1 04-29-2020