IRS ISSUES

Final UBIT Regulations Issued

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It's been three long years since Congress ambushed the nonprofit sector in its headlong rush to get huge tax cuts approved by the end of December 2017.

To add insult to injury, it's taken almost that long for the government to issue final regulations on the confusing, complex, and controversial new statutes directly affecting tax-exempt organizations.

Look Back at TCJA '17

The ill-conceived and sloppily drafted legislation was cobbled together in a 51-vote budget-reconciliation maneuver in the Senate in the final weeks of November and December 2017. The aim was to snag just enough "yes" votes without losing too many possible "no" votes.

Apparently, few legislators read much of the massive Tax Cuts and Jobs Act of 2017 (TCJA '17) bill before voting on it; some later acknowledged being "surprised" when they discovered some of the contents. To make matters worse, the legislation managers didn't bother to include the customary transition periods for new or substantially amended statutes. These new laws went into effect on January 1, 2018.

In addition to the unwelcome and surprise broadening of eligibility for the standard deduction (which lowered the number of itemizers including those claiming the charitable deduction), there were four troublesome new statutes in the Internal Revenue Code directly affecting tax-exempt organizations.

- (New) Net Investment Income Excise Tax, Internal Revenue Code section 4968
- (New) Unrelated Business Income Tax (UBIT) "Silo" Rules, Internal Revenue Code section 512(a)(6)
- (New) Excess Compensation Excise Tax, Internal Revenue Code section 4960

- (New) Tax on Transportation-Related Fringe Benefits, Internal Revenue Code section 512(a)(7)

Development of Regulatory Guidance

Since January 2018, we've written about each of these measures: the reaction of the nonprofit sector and the usual and customary development of regulatory guidance by Treasury/IRS, the administrative agencies tasked with interpreting and implementing them.

The ordinary sequence is for the government to draft and publish proposed regulations with a public-comment period of at least 60 days. Then federal officials may tweak the guidance a bit more based on the public input and eventually publish final regulations in the Federal Register. This final guidance becomes official and effective on that date or at some other specified time.

Although the government was responsive to the thoughtful input from experts and advisors to the nonprofit community, getting to the finish line here wasn't exactly smooth sailing. What's that old saying about "putting lipstick on a pig"?

A few months ago, we discussed the first set of rulemaking to be completed; see *Final "Net Investment Income" Excise Regs* (September 21, 2020). Here, we cover the UBIT "silo" rules made final on December 2, 2020. In the next post, we'll cover the just-published final regulations (January 19, 2021) for the excess compensation excise tax.

*[**Note**: One of the Biden Administration's first official acts on January 20th was to freeze all proposed rulemaking still in the pipeline anywhere in the federal government as well as to temporarily hold up (for review) anything just published in the prior 60 days. That includes the UBIT silo regulations as well as the excess compensation regulations.]*

By the way, the fourth of the new statutes was such a truly awful piece of legislation that a year ago it miraculously disappeared. See *Poof! The Nonprofit Parking Tax Is Gone* (January 7, 2020). Even last session's gridlocked Congress recognized there wasn't enough lipstick at all the cosmetics counters in the world to fix that mess.

UBIT Silo Statute

The unrelated business income tax provisions of the Internal Revenue Code have been in place for decades in section 512 of the Internal Revenue Code. Many tax-exempt organizations have long conducted business activities to raise necessary revenue to support their missions.

Under a complex set of rules, these activities are divided into "related" business activities and "unrelated" business activities. See Publication 598*, Tax on Unrelated Business Income of Exempt Organizations* (Rev. February 2019). In the case of "unrelated business income" (UBI), the sponsoring exempt organization must file a Form 990-T and pay taxes at the same rate as for-profit businesses. It's been settled since the 1950s that an organization that has multiple lines of "unrelated trades or businesses" is permitted to offset income from one or more profitable ventures against losses or deductions from one or more less successful endeavors. This aggregation procedure generally results in substantial savings.

Then Congress – out of the blue – turned these settled rules upside down in the Tax Cuts and Jobs Act of 2017. Lawmakers added a new "special rule" to section 512 for an organization with "more than 1 unrelated trade or business." Now commonly referred to as the "silo" or "bucket" requirement, it's found at section 512(a)(6)(A)-(C).

The statutory language is fairly brief: "In the case of any organization with more than 1 unrelated trade or business—(A) unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to each such trade or business and without regard to subsection (b)(12)…." The new rule continues: "…(B) the unrelated business income of such organization shall be the sum of the unrelated business taxable income so computed with respect to each such trade or business, less a specific deduction under subsection (b)(12)…." Subsection (C) makes clear that this amount cannot be less than zero.

Suddenly, the long-established aggregation method of calculating UBIT was tossed aside in favor of calculations made "separately" for each unrelated trade or business.

Preliminary Guidance

The Treasury Department and its agency, the Internal Revenue Service, recognized the upheaval hoisted upon the nonprofit community with this dramatic and sudden change, particularly since the new statute went into effect right away. "On January 1, 2018, the nonprofit community and its advisers faced difficult compliance duties with little or no guidance from the government beyond the wording of the new … statute."

More than a few people both in *and* out of government wondered what exactly is a "separate" and distinct trade or business within the meaning of the deceptively simple new section 512(a)(6). While federal tax officials fielded questions and complaints about the application of these new UBIT silo rules, they mulled over what to include in proposed regulations. As an interim measure on August 21, 2018, the Internal Revenue Service issued Notice 2018-67. "This notice discusses, and solicits comments regarding, various issues arising under § 512(a)(6) and sets forth interim guidance and transition rules relating to that section." See our discussion in *New UBIT Changes: Interim Guidance* (September 28, 2018).

A key feature of Notice 2018-67 is the reference to a standard already in existence in the business world, the North American Industry Classification System (NAICS). It's a 6-digit code-number method widely used for collecting and analyzing statistical data on the United States economy.

Under this interim guidance, nonprofits were advised they should "self-identify" the proper separate categories for each business activity. The IRS offered a temporary safe harbor: An organization would be allowed to rely on its own "reasonable, good-faith interpretation" of section 512(a)(6) to determine whether it had more than a single line of business under the NCAIS 6-digit code system.

In Notice 2018-67, the government included the standard Request for Comments, acknowledging the shortcomings of the new law: "There is no general statutory or regulatory definition defining what constitutes a 'trade or business' for purposes of the Internal Revenue Code so until final regulations are issued, possibly in 2019, this is an area fraught with confusion and many questions."

Just to make sure everyone was crystal clear about the preliminary nature of the government's thoughts in Notice 2018-67, officials added: "This is not a final or complete explanation of the new UBIT-related statutes; eventually, the Treasury Department will issue more complete and definitive regulations."

Proposed Regulations

Those federal officials got an earful in the public-comment period for Notice 2018-67. Most particularly, responding organizations along with their professional advisors, academics, and other experts pointed out the shortcomings of using the NCAIS 6-digit system; namely, that nonprofits were being asked to break "down their various unrelated business income into dozens or even hundreds of separate categories, leading to burdensome compliance costs, inconsistency, and arbitrariness."

It took over 18 months for the government to settle on, and publish, proposed regulations on April 24, 2020, *Unrelated Business Taxable Income Separately Computed for Each Trade or Business.*

See our discussion in *New UBIT "Silo" Proposed Regulations* (June 3, 2020). The key change between Notice 2018-67 and the Proposed Regulations is the reduction in the number of category selections for an organization's multiple profit-making ventures. This is accomplished by reference to the first two digits *only* of the NCAIS system – instead of the full six digits. That change collapses the menu of "separate" categories to just about twenty. In addition, an organization is permitted to group certain related types of activities together; for instance, all accommodations and food services businesses may be placed in the same category.

This notice of proposed regulations again offered the interested public a 60-day public-comment period. Respondents voiced concerns about a number of items but focused primarily on the 2-digit classification system. Twenty categories is better than hundreds, but it's still a matter of fitting square pegs into round holes.

David Thompson, vice president for public policy at the National Council of Nonprofits, sums it up well: the proposed rules are "perhaps the least bad option for implementing a very bad law."

Final UBIT Regulations

The final regulations at T.D. 9933 were published in the Federal Register and made official on December 2, 2020. A "few modifications were made in response to comments," but they "generally follow the approach taken" in the April 2020 proposed regulations. This includes continuing the approval for an organization to treat most investment activity as a single trade or business. The final regulations also add more guidance on how to identify separate trades or businesses along with how to calculate the UBIT amount.

There is a helpful summary in the *Journal of Accountancy* by Alistair M. Nevius, J.D., (November 20, 2020), in which he discusses some of the finer points made clear in the December 2, 2020 regulations:

- The organization must calculate UBIT separately for each unrelated trade or business, "without regard to the specific deduction in section 512(b)(12), including for purposes of determining any net operating loss (NOL) deduction."
- An exempt organization … "must allocate deductions between separate unrelated trades or businesses using the reasonable-basis standard described in Regs. Sec. 1.512(a)-1(c)."
- "[Q]ualifying partnership interests, qualifying S corporation interests, and certain debt-financed properties may be treated as separate unrelated trades or businesses for purposes of Sec. 512(a)(6)."

Two issues that the government (in the April 2020 proposed regulations) reserved for decision were *not* decided in the final regulations. "The IRS anticipates issuing proposed regulations on these issues in the future." They are:

- The "allocation of expenses, depreciation, and similar items that are shared between an exempt activity and an unrelated trade or business or between more than one unrelated trade or business."
- Changes in the section 172 NOL deduction made by the Coronavirus Aid, Relief, and Economic Security (CARES) Act in April 2020.

Conclusion

The final regulations apply to taxable years beginning on or after the Federal Register publication date but there are two alternatives. First, an organization may choose to apply them to earlier taxable years beginning on or after January 1, 2018. Second, an organization may rely on a reasonable, good-faith interpretation of section 512(a)(6) for such taxable years.

And, of course, pursuant to President Biden's executive order, these regulations are temporarily on hold in any event. What will happen? Who knows?

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