FPLG
FOR PURPOSE LAW GROUP
A Professional Law Corporation

NONPROFITS: UBIT/UNRELATED BUSINESS INCOME

New UBIT Changes: Interim Guidance

09.28.18 | Linda J. Rosenthal, JD

In December 2017, Congress rushed through extensive tax law changes including a sprinkling of provisions directly affecting nonprofit organizations. Many were unexpected and hastily – that is, sloppily – drafted with immediate effective dates instead of the typical phase-in schedule. 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 or amended tax statutes.

One of the most perplexing changes is the calculation of the unrelated business income tax (UBIT). The most dramatic difference relates to the treatment of an organization with more than one unrelated trade or business. Before the Tax Cut and Jobs Act of 2017 (TCJA), that organization was allowed to aggregate deductions relating to these two or more trades or business activities. An organization with a profitable business could reduce its net income subject to UBIT by setting off the expenses arising from another business that operates as a loss. This may result in substantial tax savings.

Under the new rule, organizations with more than one unrelated trade or business are governed by new section 512(a)(6) of the Internal Revenue Code, and must now calculate UBI for each trade or business separately. These groups can no longer use deductions attributable to one program to offset the income from a separate program. In addition, gains and losses must be calculated and applied separately. If a certain activity has a net loss for the year, that loss may not be used to reduce income from another activity operated by the group.

Compounding the abruptness of the change in the law is the confusion arising from this deceptively simple statutory wording of new section 512(a)(6). In particular, what is a “separate” and distinct trade or business?

As the months have passed since the effective date of January 1, 2018, the nonprofit community, their professional advisers, and academics and other experts and commentators have struggled to pin down compliance approaches and strategies. The government has been slow to react – until now.

New Notice with UBIT Guidance Issued

On August 21, 2018, the Internal Revenue Service issued Notice 2018-67 in the Federal Register. This is not a formal revenue procedure. Instead, it gives "interim" guidance and some clarity on certain of the UBIT changes.

There are five key points raised in Notice 2018-67. The IRS acknowledges that 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. Any organization that may be subject to the UBIT changes should carefully read and analyze this Notice and seek professional assistance to determine if, and how, these new rules apply.

Good-Faith Rule

Perhaps the most useful element of Notice 2018-67 is the safe-harbor rule an organization may use to determine "whether it has more than one unrelated trade or business" within the meaning of new section 512(a)(6).

Section 3 of the Notice provides that a tax-exempt organization may rely on a "reasonable, good-faith interpretation" of section 512(a)(6) to determine whether it has more than one unrelated trade or business, including use of the fragmentation principle and the *North American Industry Classification System* ("NAICS") 6-digit codes.

The NAICS is "a classification system already used on the Forms 990 and 990-T. The system groups together similar economic activities, or economic units, into defined industries that are identified using a 6-digit coding system." Relied on by federal agencies generally, it "…provides a well-defined framework for grouping unrelated business activities together."

The "fragmentation principle" in (existing) section 513(c) and Treasury Regulation 1.513-1(b) may also "be a prudent guide in the development of a nonprofit's good-faith interpretation" of whether its activities are one or several trades or businesses. A "tax-exempt organization's business activity will not lose its identity as an unrelated trade or business merely because it is carried on within a larger aggregate of similar activities that are related to the organization's exempt purposes." Before the Tax Cut and Jobs Act of 2017, this principle was "used to 'fragment' the unrelated aspects of a trade or business from the related aspects. The classic example is the sale of jewelry in an art museum gift shop (unrelated) and the sale of postcards replicating the art in the museum (related)."

Fringe Benefits and UBIT

In Section 8 of Notice 2018-67, the IRS clarifies that the amount included in UBTI for certain employee fringe benefits as a result of section 512(a)(7) will not be subject to the "silo" requirement of section 512(a)(6). While this is a helpful explanation, it doesn't eliminate all of the questions and uncertainties

about the calculation of the new UBIT fringe-benefit rules.

These new fringe-benefit rules are wildly unpopular. There are already several legislative repeal efforts proposed in Congress; stay tuned for further developments.

Other Activities

Section 4 of Notice 2018.67 explains that the Treasury Department and IRS see no distinction between the income derived from an unrelated trade or business regularly carried on by a tax-exempt organization as set forth in section 512(a)(1) and: (i) the amounts included in the unrelated business taxable income calculation as debt-financed income under section 512(b)(4); (ii) payments from controlled entities under section 512(b)(13); and (iii) certain insurance income under section 512(b)(17).

But the government recognizes "the administrative burden Treasury associated with separately tracking and reporting UBTI from each debt-financed property or controlled entity"; so, "aggregating such UBTI 'may be appropriate in certain circumstances.'"

Aggregating re: Investment Activities

Under section 5 of Notice 2018-67, the Treasury Department and IRS also "acknowledge the administrative burden in separately calculating UBTI from certain investment activities, particularly with respect to ownership interests in multi-tier partnerships." The government will "propose regulations treating certain investment activities as one trade or business for purposes of section 512(a)(6)"; this will permit the "organization to aggregate the income and losses from such investment activities."

Aggregating re: Qualifying Partnership Interest

Section 6 of Notice 2018-67 includes a new interim rule that allows an organization that "holds a (single) qualifying partnership interest that results in" unrelated business taxable income from multiple trades or businesses to aggregate it. This interim rule includes "any unrelated debt-financed income connected to" a single partnership interest if it meets one of two tests:

- "*De minimis* test": allows aggregation from the single partnership interest if the organization "holds no more than 2% of the profits interest and no more than 2% of the capital interest of the partnership."
- "Control test": allows aggregation if it "holds no more than 20% of the capital interest and does not have control or influence over the partnership."

There is an alternate transition rule because the government acknowledges that "it may be difficult" to modify a partnership interest to meet either of the above interim rules; that is, the "*de minimus* test" or the "control test." An exempt organization may treat a partnership interest acquired before August 21, 2018, as a single trade or business under section 512(a)(6), "regardless of the actual number of trades or businesses conducted by the partnership."

Of course, announcing a "transition rule" that ends the day said transition rule is publicly announced is … well ….

Request for Public Comments on UBIT Rules

The government has included the standard Request for Comments in Notice 2018-67.

The government acknowledges 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.

Conclusion

If ever there has been a need for all interested stakeholders, advisers, and experts to take action by submitting public comments and otherwise on Capitol Hill, this – certainly – is it.

— Linda J. Rosenthal, J.D., FPLG Information & Research Director