IRS Provides Guidance on New UBTI Rules

By Marc Berger, CPA, JD, LLM

On August 21, 2018, the Internal Revenue Service (IRS) released Notice 2018-67 (Notice), providing tax-exempt organizations and their tax advisors some much-needed guidance with respect to new Internal Revenue Code Section 512(a)(6). This is the provision in the new Tax Cuts and Jobs Act that requires calculation of unrelated business taxable income (UBTI) separately with respect to each unrelated trade or business.

While the IRS still intends to issue proposed regulations on this issue sometime in the future, the Notice provides some guidelines which will help exempt organizations compute their UBTI in the short-term.

Prior to enactment of Section 512(a)(6), organizations with multiple sources of unrelated business income calculated their UBTI by aggregating the gross income from all unrelated trades or businesses less the aggregate deductions allowed with respect to such unrelated trades or businesses. Section 512(a)(6), effective for tax years beginning after December 31, 2017, requires UBTI to be calculated separately for each trade or business, and that UBTI for any such trade or business shall not be less than zero. In effect, the provision prevents an organization from using a net loss from one trade or business to offset net income from another trade or business.

In enacting Section 512(a)(6) Congress did not provide criteria for determining whether an exempt organization has more than one unrelated trade or business or how to identify separate unrelated trades or businesses. While the proposed regulations to be issued will address these areas, the Notice provides interim guidance that exempt organizations can rely on in reporting UBTI on their 2018 Form 990-Ts, Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e)).

The Notice provides that in determining whether an exempt organization has more than one unrelated trade or business, it may rely on a reasonable, good-faith interpretation of the law considering all of the facts and circumstances, and that a reasonable good-faith interpretation includes using the North American Industry Classification System (NAICS) six-digit codes. Exempt organizations filing Form 990-T already are required to use the six-digit NAICS codes when describing the organization's unrelated trades or businesses in Block E on page 1 of the return. For example, all of an organization's advertising activities and related services, reported under NAICS code 541800, might be considered one unrelated trade or business activity, regardless of the source of the advertising income.

Perhaps the most important part of the Notice pertains to the reporting of an organization's income from investment partnerships. Section 512(c) requires an exempt organization that is a partner in a partnership that conducts a trade or business that is an unrelated trade or business with respect to the exempt organization to include in UBTI its distributive share of gross partnership income (and directly connected partnership deductions) from such unrelated trade or business. Reacting to comments it received from the exempt organization community regarding the potential significant reporting and administrative burden imposed by Section 512(a)(6) on exempt organizations with numerous investments in multi-tier partnership structures that generate UBTI, the IRS intends to issue proposed regulations treating certain investment activities of an exempt organization as one trade or business for purposes of Section 512(a)(6)(A). This would permit exempt organizations to aggregate gross income and directly connected deductions from such "investment activities."

Perhaps the most important part of the Notice pertains to the reporting of an organization's income from investment partnerships.

Until the regulations are issued the Notice provides an **interim rule** which allows an organization to aggregate its UBTI from its interest in a single partnership with multiple trades or businesses, including trades or businesses conducted by lower-tier partnerships. The interim rule can be used as long as the directly held partnership interest meets the requirements of either the de minimis test or the control test, which provide:

De minimis test – The partnership interest qualifies as long as the exempt organization holds directly no more than 2 percent of the profits interest and no more than 2 percent of the capital interest. Percentage interests held by certain related organizations and individuals are included in this determination.

Control test – The partnership interest qualifies as long as the exempt organization (i) directly holds no more than 20% of the capital interest in the partnership; and (ii) does not have control or influence over the partnership. Similar to the de minimis test, certain related organizations and individuals are included in this determination.

In determining the exempt organization's percentage interest in the partnership for these tests, the organization may rely on the information provided to them on Schedule K-1.

The Notice provides a **transition rule** for partnership interests acquired prior to August 21, 2018. This rule treats each partnership interest as a single trade or business, whether or not there is more than one trade or business conducted by the partnership or lower-tier partnerships. Thus, an exempt organization can treat each partnership interest acquired prior to August 21, 2018 as comprising a single trade or business for purposes of computing UBTI under Section 512(a)(6).

When Section 512(a)(6) was enacted organizations feared having to report and track the annual net income or loss from each partnership investment separately. The gist of these interim and transition rules is that an organization with numerous investment partnership interests may be able to aggregate and treat those investments as one trade or business under Section 512(a)(6).

The Notice also addresses several other issues relating to Section 512(a)(6), including the effect of new Section 512(a)(7), which increases UBTI for certain qualified transportation fringe benefits and qualified parking. The Notice states that UBTI created from 512(a)(7) is not income derived from an unrelated trade or business, and as a result, any amount included in UBTI under Section 512(a)(7) is not subject to Section 512(a)(6).

Along the same lines, the Notice provides that income reported as unrelated business income under Section 512(a)(4), reporting unrelated debt-financed income, 512(b)(13), reporting specified payments from controlled entities, and 512(a)(17), reporting certain insurance income, does not have a nexus to an unrelated trade or business. However, the Notice provides that aggregating income included in UBTI under these provisions "may be appropriate in certain circumstances."

Finally, the Notice sheds some light on the use of net operating loss (NOL) carryforwards from years beginning prior to the effective date of Section 512(a)(6) (Pre-2018 NOLs). These NOL carryforwards are allowed to be used against UBTI as calculated under Section 512(a)(6). The organization will first calculate UBTI for each separate trade or business under Section 512(a)(6)(A), and then apply an NOL carryforward to those trades or businesses with UBTI under Section 512(a)(6)(B). This will have the effect that post-2017 NOLs will be calculated and taken before pre-2018 NOLs (because UBTI with respect to each separate trade or business is calculated under Section 512(a)(6)(A) before calculating total UBTI under 512(a)(6)(B)).

Notice 2018-67 is a good first step in providing exempt organizations some guidance on this one provision in the new law. Stay tuned for additional guidance in the future with respect to all of the tax changes affecting exempt organizations.

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