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CLIENT ALERT

Proposed Regulations Change Calculation of Unrelated Business Taxable Income, Reducing Administrative Burden and Taxes Paid by Some Exempt Organizations

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Treasury and the IRS recently published proposed regulations with welcome guidance regarding how exempt organizations are to calculate unrelated business taxable income (UBTI). The proposed regulations clarify the calculation under Section 512(a)(6), which requires exempt organizations to compute UBTI separately for each unrelated trade or business. Section 512(a)(6) and the proposed regulations will affect all organizations with more than one unrelated trade or business and investment income, regardless of the amount of UBTI. The proposed regulations specifically reject a carve-out proposed by tax practitioners for exempt organizations with less than $100,000 of gross UBTI. All organizations should, therefore, be aware of the proposed regulations and may want to consider strategically restructuring unrelated trades or businesses and investment activities to minimize UBTI and to comply with the many detailed rules contained therein.

In general, the proposed regulations will decrease the administrative burden on exempt organizations to calculate UBTI, as compared to the rules provided in Notice 2018-67. The proposed regulations will also decrease the UBTI of some exempt organizations, as compared to Notice 2018-67, because the proposed regulations reduce the number of "silos" for separate unrelated trades or businesses, resulting in a greater aggregation of income and losses. Despite this relative decrease in taxation, the tax community and exempt organizations have already expressed their discontent with the proposed regulations for not exempting smaller organizations from the onerous requirements of Section 512(a)(6) and for not temporarily suspending Section 512(a)(6) for all exempt organizations during the pandemic and related economic downturn.

Background

Section 512 of the Internal Revenue Code (the "Code") imposes a tax on gross income derived from unrelated trades or businesses regularly carried on by exempt organizations. An unrelated trade or business is any trade or business that is not substantially related to the exercise or performance by the exempt organization of its charitable, educational, or exempt function.

Prior to the Tax Cuts and Jobs Act (TCJA), the IRS required exempt organizations to aggregate the gross income (and associated deductions) for all unrelated trades or businesses. Through aggregation, exempt organizations could use losses from one trade or business to offset income from another trade or business. The TCJA, specifically the new Section 512(a)(6), changed this aggregation rule and required organizations to compute UBTI separately for each trade or business, in separate silos. Treasury and the IRS provided interim guidance and solicited comments regarding the new Section 512(a)(6) in Notice 2018-67. The proposed regulations respond to these comments and provide details regarding (i) what is a separate unrelated trade or business, (ii) how are businesses to calculate UBTI for these separate unrelated trades or business, and (ii) how are investment activities, including partnership income, and net operating losses to be treated.

What Is "Siloed" as a Separate Unrelated Trade or Business?

The proposed regulations provide that exempt organizations are to use a two-digit North American Industry Classification System (NAICS) code to identify separate unrelated trades or businesses. There are twenty separate two-digit NAICS codes. Common two-digit codes include: Real Estate and Rental and Leasing, Educational Services, Accommodation and Food Services, etc. Exempt organizations are to use the code that identifies the specific unrelated trade or business and not the code that describes the organization's overall exempt activity. Therefore, for example, a museum with UBTI from a café and a restaurant would use Code 72, Accommodation and Food Services, and not Code 71, Arts, Entertainment, and Recreation to calculate the UBTI for the café. Furthermore, if an organization operates multiple unrelated trades or businesses in different geographic areas, such as a tax-exempt hospital with pharmacies in different states, the hospital would calculate the UBTI for all pharmacies using a single two-digit code, even though the separate pharmacies may be distinct, separate trades or businesses for other tax purposes.

Previously, Notice 2018-67 provided that exempt organizations were to use a six-digit NAICS code. The six-digit system required significant siloing and prevented most aggregation because there are over a thousand six-digit NAICS codes with varying levels of specificity. For example, under Notice 2018-67, the museum discussed above would be unable to offset losses from the café against income from the restaurant as the six-digit codes distinguish between Cafeterias, Grill Buffets, and Buffets, 722514, and Full-Service Restaurants, 722511.

Notice 2018-67 put a substantial burden on exempt organizations to correctly categorize and calculate UBTI for all separate unrelated trades or businesses. In response to taxpayer comments and concern, the proposed regulations significantly reduce the maximum number of trades or businesses from thousands to twenty, thereby reducing the administrative burden of reporting UBTI. However, as the proposed regulations note, the NAICS codes are revised periodically, and exempt organizations must be mindful of such revisions and annually evaluate which codes apply to all separate trades or businesses, thereby increasing the administrative burden on exempt organizations. Please find all NAICS codes here.

How to Calculate UBTI for Separate Trades or Businesses

Even with the simplified two-digit system, calculating UBTI across trades and businesses remains complicated. After determining the proper two-digit classification, exempt organizations are to determine which costs (and therefore deductions) apply to that trade or business. Exempt organization can generally deduct costs directly connected with the carrying on of the separate unrelated trade or business, silo-by-silo.

The proposed regulations look to Treasury Regulation § 1.512(a)-1(c), which outlines special rules for allocating expenses that are shared between an exempt activity and an unrelated trade or business and provide that the exempt organization is to allocate expenses using any reasonable basis. Notice 2018-67 stated that Treasury and the IRS were considering modifying the underlying reasonable basis allocation method of Treasury Regulation § 1.512(a)-1(c) as it applied to separate unrelated trades and businesses. The proposed regulations provide that Treasury and the IRS are continuing to consider the reasonable basis allocation method and intend to publish forthcoming guidance. Until Treasury and the IRS publish such separate guidance, exempt organizations may continue to allocate expenses using any reasonable method. However, the proposed regulations also specify that the unadjusted gross-to-gross method of allocation is not a reasonable allocation method. Treasury and the IRS further request comments regarding (i) whether any other allocation method, in addition to the unadjusted gross-to-gross method, should be considered unreasonable, and (ii) the methods or rules that could be adopted instead of a reasonableness basis standard for allocation.

For example, if the museum discussed above included a gift shop in addition to a café, then the museum would need to allocate overhead expenses between "Accommodation and Food Services" and "Retail Trade," including expenses for employees, commercial supplies, and the like using any reasonable basis. This will require the museum, like all exempt organizations, to closely monitor and track income and expenses for the different trades and businesses. In some instances, the compliance costs may exceed the income and benefit derived from smaller trades or businesses.

Investment Activities

The proposed regulations confirm that, generally speaking, an exempt organization's investment activities are treated as a separate unrelated trade or business for purposes of Section 512(a)(6). The proposed regulations further provide that exempt organizations may aggregate specified investment activities and treat the activities a single unrelated trade or business. The proposed regulations then list activities that may be aggregated in that single investment trade or business, including qualifying partnership interests, debt-financed income, and qualifying S corporation interests. The proposed regulations exclude investment income from controlled entities under Section 512(b)(13) and controlled foreign corporations under Section 512(b)(17) from this list and provide that such income is not to be aggregated with other investment income.

Qualifying Partnership Interest

An exempt organization's interest in a partnership or other pass-through entity is a qualifying partnership interest (QPI), which may be aggregated as one investment trade or business if the exempt organization meets the requirements of either the "de minimis test" or the control test. The de minimis test requires that the exempt organization (i) hold no more than 2 percent of the profits interest and (ii) hold no more than 2 percent of the capital interest of the partnership directly or indirectly.

The control test requires that the exempt organization (i) hold no more than 20 percent of the capital interest in the partnership and (ii) not have control over the decision making of the partnership. The proposed regulations provide that the 20 percent threshold was included as a proxy to identify partnership interests in which the exempt organization does not significantly participate and therefore considers as an investment activity. Notably, exempt organizations are no longer required to combine certain related interests to determine whether the partnership interest passes the de minimis or control test. For example, exempt organizations no longer need to combine the interests of disqualified persons (e.g., foundation managers, major contributors, and their families) with that of the exempt organization to determine if the exempt organization controls the partnership. However, exempt organizations now are to combine the interests held by supporting organizations and controlled organizations to determine if the organization meets the 20 percent threshold for the control test. In general, for the control test, the IRS will continue to look to all facts and circumstances to determine if an exempt organization controls a partnership. In addition to the two tests, the proposed regulations contain many other detailed rules for partnership interests, including "look-through" rules for indirect interests in lower-tier partnerships and rules related to reliance on Schedule K-1.

Debt-Financed Income

The proposed regulations provide that exempt organizations may include debt-financed income as a single trade or business, similar to QPI discussed above. Debt-financed property is any property that is held to produce income and which resulted in acquisition indebtedness. The Code taxes debt-financed income as UBTI generally. The proposed regulations specifically provide that interest and dividend income, and the like, which is UBTI because the income is derived from debt-financed property, may be treated as income from investment activity and included in a single investment silo. However, the proposed regulations also provide that if the debt-financed income would be UBTI even if the income was not debt-financed income, such as rents from real and personal property, then the income is to be treated separately from investment activity, with a separate two-digit NAICS code (i.e., Code 52, Real Estate and Rental and Leasing).

Net Operating Losses

The proposed regulations also address net operating losses (NOLs). The proposed regulations provide that NOLs that arise in taxable years beginning after December 31, 2017 (the "post-2017 NOLs") are to be applied to each separate trade or business, silo by silo. In comparison, NOLs arising in taxable years beginning before January 1, 2018 (the "pre-2018 NOLs") are to be deducted from the total aggregated UBTI. Exempt organizations are to maximize utilization of pre-2018 NOLs before deducting any post-2017 NOLs.

The proposed regulations do not discuss in detail the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") and the provisions of the CARES Act that changed the deduction of NOLs generally. The CARES Act temporarily suspended the limitation on NOLs (i.e., NOLs limited to 80 percent) enacted with the TCJA. The CARES Act also allowed organizations to carry back NOLs for 2018, 2019, and 2020 for the five years preceding the loss. These rules also apply to exempt organizations. The proposed regulations provide that Treasury and the IRS may issue additional guidance regarding NOLs, including guidance relating to ordering rules of NOL carryovers and excess contributions, and the overlap of the CARES Act and the proposed regulations.

Applicability of Proposed Regulations

Exempt organizations may rely on the proposed regulations in their entirety until Treasury and the IRS promulgate final regulations. Treasury and the IRS have indicated that they anticipate finalizing the proposed regulations in 2020. The proposed regulations in turn ask that practitioners and exempt organization submit any comments and any requests for a public hearing by June 23, 2020. The proposed regulations also provide that, in the interim prior to promulgation of the final regulations, exempt organization may alternatively rely on Notice 2018-67 and upon the methods of aggregating or identifying separate trades or businesses contained therein. Therefore, exempt organizations that have already undertaken the administrative burden of determining UBTI under Notice 2018-67 may continue to rely on Notice 2018-67 and do not need to recalculate UBTI under the proposed regulations and thereby incur additional administrative costs.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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