Tax Insights
from Exempt Organizations

UBTI proposed regulations clarify uncertainties, but questions remain

April 27, 2020

In brief

The IRS on April 23 released proposed regulations (Proposed Regulations) under Section 512(a)(6) requiring segmentation of unrelated business taxable income (UBTI). The Proposed Regulations adopt aspects of interim guidance in Notice 2018-67, including:

- Reliance on North American Industry Classification System (NAICS) codes to identify separate trades or businesses (the Proposed Regulations adopt of a system of 2-digit codes versus 6-digit codes described in the Notice),
- Modification of the ‘de minimis’ and ‘control’ tests for aggregating partnership investments (first described in the Notice), and
- Descriptions of topics not covered in the Notice, such as the ordering of net operating losses (NOLs).

In detail

Section 512(a)(6), added by the 2017 tax reform legislation, requires a tax-exempt organization with more than one unrelated trade or business to calculate its UBTI separately for each trade or business, effective for tax years beginning after December 31, 2017. For tax years beginning before January 1, 2018, an organization that operated multiple unrelated trades or businesses could aggregate the gross income and allowable deductions from all such activities. Notice 2018-67 provided interim guidance on the definition of a trade or business for this purpose.

The Proposed Regulations, which modify and expand on the interim guidance in Notice 2018-67, provide that:

- NAICS 2-digit codes generally must be used to identify an organization’s separate trades or businesses. All activities under the same 2-digit code must be aggregated since codes may be used only once. An organization that has identified the 2-digit code for a particular trade or business may not change the code describing that trade or business unless the code was chosen in error.
- Certain investment activities may be aggregated as one trade or business. Investment activities are defined as qualifying partnership interests (QPIs), S-corporation interests, and debt-financed property.

- A QPI must meet the requirements of either the de minimis test or the control test. An organization's partnership interest generally meets the de minimis test if the organization directly or indirectly holds no more than 2% of the profits or capital interest. An organization's partnership interest meets the control test if the organization holds no more than 20% of the capital interest and does not 'control' the partnership. A partnership interest held as a general partner is not a QPI.
- An organization may look through a direct partnership interest that does not qualify as a QPI and treat an indirectly held partnership interest as a QPI if the indirectly held partnership interest meets the requirements of the de minimis test.
- Charitable contributions are deducted after the aggregation of the trades or businesses that have positive taxable income. The deduction does not need to be allocated among the trades or businesses.
- Deductions should be allocated among trades or businesses on a reasonable basis as determined in good faith by the organization until the IRS provides further guidance on the allocation of other deductions.
- Organizations should deduct a pre-2018 NOL from UBTI prior to deducting a post-2017 NOL within each UBTI segment.

The IRS will (1) consider how the Coronavirus Aid, Relief, and Economic Security Act's temporary repeal of the 80% NOL limitation should affect the UBTI calculation, and (2) update the Form 990-T, *Exempt Organization Business Income Tax Return*, and related schedules and instructions as appropriate.

Observations

Although the Proposed Regulations adopt certain standards similar to those in Notice 2018-67, they also modify parts of the earlier guidance. The Notice permitted a reasonable, good-faith interpretation of existing UBTI rules when determining whether an exempt organization has more than one unrelated trade or business. The Proposed Regulations instead provide more bright-line rules with limited flexibility.

The Proposed Regulations generally require use of NAICS 2-digit codes for reporting separate trades or businesses, except for investment activities and certain other exceptions. Organizations may be required to separate fewer trades or businesses to comply with the 2-digit coding than they originally had anticipated to comply with the 6-digit coding as referenced in the Notice.

The Proposed Regulations require the use of de minimis and control tests for aggregating investment partnership interests. Partnerships in which an organization owns greater than a 20% capital interest would not be includible in the investment segment. The Proposed Regulations allow organizations to look through directly held partnerships that do not qualify as QPI to apply the de minimis test. This rule allows an organization to aggregate trades or businesses held in non-QPI partnerships with other investment activities. However, significant administrative and complex compliance efforts may be required to apply the look-through rule.

Effective date

The Proposed Regulations are proposed to apply to tax years beginning on or after the date the final regulations are published in the Federal Register. Prior to that date, the Proposed Regulations state, organizations may rely on a reasonable, good faith interpretation of existing UBTI rules. Alternatively, organizations may rely on the Proposed Regulations in their entirety or on the methods described in Notice 2018-67 to identify separate unrelated trades or businesses.

Request for public comments

The Proposed Regulations are open for written or electronic comment until June 23, 2020. Comments must be submitted through the Federal electronic rulemaking portal or sent in paper copy to the IRS. Comments received will be published in the agency's public docket.

The takeaway

Although the Proposed Regulations are not yet binding, organizations should consider analyzing their potential impact on their UBTI reporting. Organizations may consider submitting comments to the IRS in response to the Proposed Regulations.

Let's talk

If you have questions, please contact:

Exempt Organization Tax Services

Rob Friz
robert.w.friz@pwc.com

Travis Patton
travis.patton@pwc.com

Gwen Spencer
gwen.spencer@pwc.com

Michelle Michalowski
michelle.g.michalowski@pwc.com

Laura J. Parello
laura.j.parello@pwc.com

Meet our Exempt Organization Tax Services team

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