The Tax Cuts and Jobs Act changed the way tax-exempt organizations calculate their unrelated business taxable income (UBTI). No longer can organizations follow the rules used by taxable entities and aggregate income and deductions from all of their unrelated trades or businesses. Rather, new code section 512(a)(6) requires organizations to separately compute their UBTI for each “trade or business” and prohibits using losses from one trade or business to offset gains in another. Section 512(a)(6) raises numerous questions, among them: how to determine separate trades or businesses; how to treat debt-financed income; how to treat income from partnerships; and how to calculate both new and historic net operating losses.

Notice 2018-67, issued on August 21, 2018, provides preliminary answers. It also foreshadows the IRS’s thoughts for proposed regulations while asking organizations to provide comments before regulations are issued. The IRS is not delaying the implementation of 512(a)(6); it is effective now. However, the Notice makes clear that the IRS will not penalize organizations if they use a reasonable, good-faith interpretation in calculating their UBTI. Organizations that choose to use the specific accounting methods described in the Notice will meet the requirement for having a reasonable, good-faith interpretation.

I. Identifying Trades or Businesses

The Notice proposes that organizations distinguish between their trades or businesses by using the business codes contained in the North American Industry Classification System (NAICS). NAICS codes are used across the Federal government to provide statistical data on the United States business economy. The IRS also uses NAICS codes in a variety of ways, including on the Form 990-T. By selecting a categorization that is already in use, the IRS is attempting to reduce the reporting burden arising from the new rules. These codes should be useful for aggregating some activities, such as advertising. However, the codes may not adequately address all of an organization’s activities. Accordingly, the IRS is seeking comments on whether this method, or others, is appropriate for identifying separate trades or businesses.

II. Investment Income and Partnership Activities

For exempt organizations with significant investment portfolios, the most important issue in Notice 2018-67 is likely to be the treatment of partnership income. Partnership investments can generate UBTI, even when the organization’s interest is purely passive. The IRS recognizes the need for rules that will govern the treatment of gains and losses from such investments in the new UBIT regime. The Notice states that the agency is considering establishing a category for “investment activities” to aggregate all of an organization’s income, deductions, and losses from investments. They are seeking comments on how to define such a category.

In the interim, the Notice creates a safe harbor for certain partnership investments. Under the IRS’ proposal, organizations may aggregate income from a single partnership that conducts multiple trades or
businesses (either directly or through lower-tier partnerships), if the holdings are “qualifying partnership interests.” Organizations may also aggregate income and losses across all qualifying partnership interests and treat them as a single investment activity.

The definition of qualifying partnership interest appears to derive from the excess business holding rules applicable to private foundations—a set of rules for issues that are completely unrelated to section 512(a)(6). Under this approach, in order to be a qualified partnership interest, a partnership investment must meet either a De Minimis Test (constituting no more than 2% of the profits and capital interests in the partnership) or a Control Test (constituting less than 20% of capital interest and providing no control or influence over the partnership). The Notice offers additional guidance on calculating interests from the partnership’s Schedule K-1, in attributing interests from related parties, and on the treatment of unrelated debt financed income. There is also a transition rule for partnership interests acquired before August 21, 2018 that do not meet the above tests. This transition rule allows an organization to treat all income earned from a single grandfathered partnership as income from a single trade or business. However, it does not explicitly authorize aggregating income across such partnerships.

III. Miscellaneous Guidance

The Notice contains guidance on unrelated debt-financed income, income from controlled entities, and insurance income from controlled foreign corporations. The IRS proposes that these categories of income should be treated as deriving from separate trades or businesses and therefore calculated separately. Recognizing that this approach could be burdensome, the IRS states that aggregation may be appropriate in certain circumstances and requests comments.

The IRS has identified that guidance is needed on the interaction between the general rules governing net operating losses and the new requirements under section 512(a)(6). Several complications are identified and the IRS is requesting comments on how to resolve these issues.

The Notice also addresses the need for guidance on the allocation of expenses for dual use facilities—an item that has been pending on the IRS’s Priority Guidance Plan for several years. Additional guidance for allocating expenses is needed since organizations may also need to allocate expenses across separate trades or businesses.

Finally, the Notice provides information on two other provisions added by the Tax Cuts and Jobs Act. First, amounts that are taxable under the new section 512(a)(7) fringe benefit rules will not be treated as a trade or business for purposes of UBTI. This means that organizations with only one unrelated trade or business will not suddenly fall within the scope of section 512(a)(6) if they also provide transportation fringe benefits. Second, the IRS will treat Global Intangible Low-Taxed Income (GILTI), a new category of income arising in certain international investments, as though it were a dividend, which is similar to how it treats most other income from controlled foreign corporations for unrelated business income purposes.

For more information on this Alert or more general information on unrelated business taxable income reporting requirements, please contact a member of Caplin & Drysdale’s Exempt Organizations team.

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