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IRS Releases Interim Guidance for Exempt Organizations on New Unrelated Business Income Tax Rules

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The IRS and Treasury Department recently released new guidance for calculating the tax on unrelated business income (“**UBI**”) activities of tax-exempt organizations with more than one UBI activity. With the passage of the 2017 Tax Cuts and Jobs Act (the “**Tax Act**”), exempt organizations are required to calculate UBI tax separately for each UBI activity for taxable years beginning after December 31, 2017. Under prior law, exempt organizations could use the losses from one UBI activity to offset income from another.

The new guidance is found in Notice 2018-67 (the “**Notice**”) and provides that exempt organizations may rely on a “reasonable, good-faith interpretation” of the UBI sections of the Internal Revenue Code in determining whether they have more than one UBI activity. The Notice also guides tax-exempt organizations through calculating the tax on UBI activities for certain nontaxable fringe benefits, such as parking provided to their employees. Besides providing guidance, The Notice also requests comments through December 3, 2018 from the public regarding forthcoming proposed regulations on the matter.

Description of the New UBI Provisions.

Under the newly enacted IRC Section 512(a)(6), a tax-exempt organization can no longer aggregate their income and expenses from their various UBI activities to offset the income of the profitable activities against the losses from other activities. Instead, the new provisions effectively require exempt organizations to create “silos” or “buckets” for each UBI activity and determine the net income or loss from each. Losses from a UBI activity in one taxable year may be used to offset income only from the same activity in a subsequent taxable year. Determining separate UBI activities of an exempt organization is critical for calculating the tax from each of the UBI activities.

Determining a Separate UBI Activity

The new Section 512(a)(6) does not set forth criteria for determining whether a tax-exempt organization has more than one UBI activity, or for distinguishing



among an organization's separate UBI activities. The Notice provides that pending issuance of the proposed regulations, an exempt organization may rely on a reasonable, good-faith interpretation of the UBI rules in determining whether it has more than one UBI activity, including using the North American Industry Classification System (NAICS) six-digit codes. In addition, the Notice states that aggregating all debt-financed income or all income from controlled entities may be appropriate in certain circumstances.

Aggregation of Investment Activities

- The Notice states that for administrative convenience the applicable proposed regulations, once issued, are intended to treat certain investment activities as a single UBI activity.
- The Notice sets forth an "interim rule" for qualifying partnership interests (defined below) and a "transition rule" for other partnership interests acquired prior to August 21, 2018 to aggregate investment activities pending publication of the proposed regulations.
- According to the Notice, these rules should capture partnership interests in which an exempt organization does not significantly participate in the partnership UBI activity.
- These rules apply to partnerships and to LLCs taxed as partnerships.

The Interim Rule

- A tax-exempt organization may aggregate all UBI activities from its interest in a single partnership with multiple UBI activities (including those conducted by lower-tier partnerships) as long as the organization's directly-held interest in the partnership is a "qualifying partnership interest" because it meets either a **de minimis test** or a **control test**. Under the Notice, a tax-exempt organization may also aggregate all qualifying partnership interests as a single UBI activity.

De Minimis Test. A partnership interest meets the de minimis test if the tax-exempt organization directly holds no more than two percent of the profits and capital interests of the partnership. Interests held by disqualified persons, supporting organizations and controlled entities are taken into account in determining an exempt organization's percentage interest.

Control Test. A partnership interest meets the control test if the tax-exempt organization

- directly holds no more than 20 percent of the capital interests of the partnership; and
- does not have control or influence over the partnership.

The Transition Rule

- Under the Transition Rule, if an exempt organization's partnership interest does not meet the de minimis or control test but was acquired prior to August 21, 2018, the organization may treat its partnership interest as a single UBI activity whether or not there is more than one UBI activity directly or indirectly conducted by the partnership or lower-tier partnerships.

Unrelated Debt-Financed Income from Investment Partnerships

- Any unrelated debt-financed income that arises in connection with a partnership interest may be aggregated with respect to any partnership for which an exempt organization applies the interim rule (i.e., the de minimis test or the control test).
- Similar to the interim rule, any unrelated debt-financed income connected to the partnership interest that meets the transition rule may be aggregated with other UBI activities resulting from that partnership interest.

Treatment of Certain Employee Fringe Benefits

- The Tax Act also enacted Section 512(a)(7), which requires exempt organizations to include as UBI costs incurred associated with providing certain employee fringe benefits, such as parking to employees. The Notice states that while Section 512(a)(7) imposes UBI tax, the IRS does not consider providing employee transportation or parking benefits to be a UBI activity, and therefore UBI tax arising from these fringe benefits under Section 512(a)(7) is not subject to the Section 512(a)(6) siloing rules.

Treatment of GILTI

- The Tax Act added Section 951A, which requires each U.S. shareholder of a controlled foreign corporation to include in gross income its share of





the corporation's global intangible low-taxed income ("GILTI").

- According to the Notice, GILTI will be treated in a similar manner to Subpart F income and will generally be treated for UBI purposes as dividend income (which is generally excluded from UBI tax) provided it is not attributable to insurance income.

NOLs and UBI Tax

- Prior to the Tax Act, NOLs generally could be carried back two years and carried forward 20 years. The Tax Act eliminated the carryback period and provides that NOLs may be carried forward indefinitely, but effectively limits the applicability of post-2017 NOLs to 80% of taxable income. This change applies to all organizations, not just to tax-exempt organizations.
- The new siloing rules for exempt organizations may have changed the order in which NOLs would ordinarily be claimed because the rules seem to require post-2017 NOLs be applied first in calculating UBI tax for each separate UBI activity.
- The IRS and Treasury Department are requesting comments on the ordering of pre-2018 NOLs and post-2017 NOLs and the potential treatment of pre-2018 NOLs that may expire if not taken prior to the post-2017 NOLs.

Reliance and Request for Comments

- Tax-exempt organizations can rely on the provisions of the Notice for taxable years beginning after December 31, 2017 until proposed regulations are published.
- Exempt organizations can submit comments regarding the forthcoming proposed regulations until December 3, 2018.

Conclusion

The Notice provides guidance to tax-exempt organizations on determining their separate UBI activities under the new UBI bucketing rules, including the aggregation of partnerships interests for UBI purposes, and requests comments on the forthcoming proposed regulations. If you would like to discuss the Notice or its impact on your exempt organization, please contact one of the following attorneys in our Nonprofit Organizations practice:

- **Thomas J. Schenkelberg** / Practice Area Chair / 816.360.4124 / tschenkelberg@polsinelli.com
- **Douglas K. Anning** / Practice Area Vice-Chair / 816.360.4188 / danning@polsinelli.com
- **Virginia C. Gross** / 816.360.4157 / vgross@polsinelli.com
- **Jonathan S. Blum** / 214.661.5576 / jblum@polsinelli.com
- **Alicia M. Beck** / 816.572.4486 / abeck@polsinelli.com





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For questions regarding this alert or to learn more about how it may impact your business, please contact one of the authors, a member of our **Nonprofit Organizations** practice, or your Polsinelli attorney.

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