Tax Cuts and Jobs Act
Interim Guidance on UBTI Siloing Rules

On August 21, 2018, the IRS issued Notice 2018-67, which includes a request for comments with interim guidance regarding how to apply the new unrelated business taxable income (UBTI) "siloing" rules of section 512(a)(6) of the Code. That section, added as part of the Tax Cuts and Jobs Act of 2017, generally provided that tax-exempt organizations can no longer aggregate income and deductions from different trades or businesses. For example, a university that both provides public parking services and rents out space for conferences can no longer use losses or deductions from one of those activities to offset unrelated business taxable income from the other.

The new code section, however, did not provide any guidance regarding how to separate one trade or business from another, or how to treat UBTI arising from activities other than direct trades or businesses (such as investments in partnerships, debt-financed income, and deemed income from the value of certain fringe benefits under new section 512(a)(7) of the Code).

In addition to asking the public for comments on each of these topics, Notice 2018-67 has provided the following interim guidelines, pending issuance of proposed regulations:

- NAICS Codes: Exempt organizations may use the North American Industry Classification System (NAICS) 6-digit codes (listed in the Instructions to the Form 990-T) to determine which activities constitute separate "trades or businesses."
    - Exempt organizations are not required to use the NAICS codes – rather, they can use any reasonable, good-faith method to sort activities into different trades or businesses. While the NAICS codes may work for some, for others those categories may not overlap well with actual activities. Each organization should consult with its advisors to determine whether use of the NAICS codes makes sense for it, or whether a different reasonable, good-faith method might better reflect actual operations.

- Deductions: Deductions attributable to more than one trade or business must be reasonably allocated among them, just as organizations must currently do when allocating deductions between exempt-function activities and unrelated business activities.

- **Investment Activity:** While investments in stock generally do not result in UBTI (as long as the organization does not borrow money to purchase the stock), investments in entities taxed as partnerships might result in UBTI. This is because tax-exempt organizations who are partners in a partnership are treated for tax purposes as if they are engaging in the underlying activities directly. The IRS notes that a strict interpretation of the new rules would require separate treatment of each underlying trade or business, which is impractical. Accordingly, for administrative convenience, the IRS will allow organizations to treat as one trade or business all "qualifying partnership interests" that meet either of the following two tests:

    - *The "De Minimis Test"* is met with respect to partnership interests involving no more than 2 percent of the profits interest and no more than 2 percent of the capital interest (with some rules for aggregating interests held by certain related parties).

    - *The "Control Test"* is met with respect to partnership interests involving no more than 20 percent of the capital interest (subject to aggregation rules) where the tax-exempt partner has no control or influence over the partnership (based on all facts and circumstances).

    - Under a special transition rule, the IRS will allow interests in a partnership acquired prior to August 21, 2018, to be treated as a single trade or business, even if there are different trades or businesses at underlying partnership levels. Presumably (although the Notice does not address this), additional interests in the same partnership acquired on or after August 21, 2018, would not be eligible for that transition rule.

- **Debt-Financed Property:** The IRS notes that a strict interpretation of the new rules would likely require treating UBTI from each debt-financed property as a separate trade or business, but acknowledges that such an interpretation could pose an undue burden on many organizations, and requests comments on how to treat such income. In the meantime, tax-exempt organizations should work with their advisors to determine a reasonable, good faith method for grouping or separating debt-financed UBTI activity into different trades or businesses.

    - The transition rule described above regarding interests in partnerships applies whether or not that partnership income results from debt-financed property. Accordingly, for partnership interests that fall within the transition rule, UBTI from debt-financed property in those partnerships may be treated together with other UBTI in those partnerships as part of a single trade or business.

- **Fringe Benefits:** Deemed UBTI from the value of certain fringe benefits under new section 512(a)(7) of the Code is not treated as an unrelated trade or business at all, and therefore is not subject to these aggregation rules.
    - The IRS has not yet issued guidance on how to interpret this new fringe benefits tax, including what sorts of benefits will trigger the tax.

- **Net Operating Losses:** While operating losses generated during taxable years beginning after December 31, 2017, can only be used to offset UBTI from the same trade or business, prior NOLs can be used to offset any UBTI. There is, however, uncertainty regarding application of the new 80 percent income limitation of section 172(a) of the Code (allowing past deductions only up to 80 percent of current year income), as well as whether pre-2018 NOLs should be applied before or after post-2017 NOLs when both are available. The IRS has requested comments on these questions.

- **GILTI**: The IRS has confirmed that deemed inclusion of GILTI (global intangible low-taxed income) from certain foreign company holdings generally will not be treated as UBTI.

- **Social Clubs, VEBAs and SUBs:** Because they are generally taxed differently than other 501(c) organizations, special rules apply to social clubs (under section 501(c)(7)), voluntary employees' beneficiary associations (VEBAs, under section 501(c)(9)), and supplemental unemployment compensation benefits trusts (SUBs, under section 501(c)(17)).

Hemenway & Barnes will continue to monitor IRS guidance regarding the Act and its potential effect on its college and university clients.

Additional Resources

- H&B Client Advisory: Tax Cuts and Jobs Act - Colleges and Universities (December 2017)

Contact Us

For more information, or to discuss potential strategies for addressing these issues, please contact a member of our Nonprofit Group, or the author of this advisory:

Brad Bedingfield
617.557.9704
bbedingfield@hembar.com

Nonprofit Group

Michael J. Puzo
Stephen W. Kidder
Arthur B. Page
Joan Garrity Flynn
Nancy B. Gardiner
Teresa A. Belmonte
Joseph L. Bierwirth
Brian C. Broderick
Charles Fayerweather
Thomas L. Guidi
Nancy E. Dempze
Dennis R. Delaney
John J. Siciliano
Charles R. Platt
Ryan P. McManus
Brad Bedingfield
M. Patrick Moore

Of Counsel
Michael B. Elefante
Susan Hughes Banning
Frederic J. Marx

www.hembar.com

Hemenway & Barnes LLP