

Nonprofit Alert: IRS Releases New Proposed UBTI “Siloing” Regulations with Slightly More Flexibility, Guidance for Nonprofits

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On April 23, 2020, the IRS published new proposed regulations with guidance on how nonprofits should calculate their unrelated business taxable income, or UBTI, for separate trades or businesses. This long-awaited guidance, once finalized, will provide some additional clarity and flexibility to nonprofits in aggregating income and expenses from similar types of trades or businesses and investment activities. It also provides additional detail on the application of net operating losses, treatment of debt-financed income, and the interplay of UBTI and the public support test. The IRS has invited comments on the proposed regulations, which must be submitted by June 23, 2020.

Background of UBTI Siloing Rule

Prior to 2017, a tax-exempt organization that carried on more than one trade or business was permitted to aggregate all of its income and expenses from those activities in calculating its net UBTI. For example, a nonprofit that operated both a profitable restaurant and a gift shop that operated at a loss was allowed to use the gift shop's losses to offset the restaurant's income.

The 2017 Tax Act added a new Section 512(a)(6) of the Internal Revenue Code, which introduced the new "siloing" concept with respect to UBTI. This Section requires that a tax-exempt organization that has more than one unrelated trade or business must compute UBTI separately for each trade or business. This change had the effect of prohibiting nonprofits from using losses of one trade or business to offset the income of another trade or business — generally resulting in higher taxes on income from such activities.

The enactment of Section 512(a)(6) created a good deal of uncertainty in the nonprofit sector with respect to how to apply the new siloing rules, in large part because the new law came with no clear criteria as to how a nonprofit should identify "separate" trades or businesses for purposes of calculating UBTI. The IRS published interim guidance in August 2018 (Notice 2018-67) stating that nonprofits may rely on any reasonable, good-faith interpretation of the UBTI rules, but it provided few specifics and left many questions unanswered.



Proposed Regulations

1. Use of NAICS Codes

One of the most helpful provisions of the proposed regulations permits nonprofits to identify their separate trades or businesses using the first two digits of the six-digit North American Industry Classification System (NAICS) code that most accurately describes the trade or business. NAICS codes are arranged so that each digit represents an increasing level of specificity. The two-digit NAICS codes generally represent 20 different sectors of economic activity. The IRS had previously stated in Notice 2018-67 that use of NAICS six-digit codes would be one reasonable method of categorizing trade or business activities. Because there are more than 1,000 NAICS six-digit codes, this standard would have placed a significant administrative burden on nonprofits. By contrast, permitting use of two-digit NAICS codes means that nonprofits will more easily be able to categorize their unrelated activities, and will be able to group together similar trades or businesses more broadly into one "silo" for UBTI purposes. As a result, nonprofits can offset income from one activity using expenses from another similar activity as long as they are classified in the same broad industry sector.

It will be important for nonprofits to carefully select the two-digit code that represents a particular trade or business. Once an organization uses a two-digit code to classify an unrelated trade or business on its IRS Form 990-T, it generally cannot change the code unless there was an unintentional error in the initial classification. The preamble to the proposed regulations indicates that the Treasury Department and the IRS "anticipate" that the Instructions to Form 990-T will be revised to describe how an organization should report such an error.

2. Investment Activities

The proposed regulations generally permit a nonprofit to aggregate investment activities collectively into one UBTI silo so long as they meet either a "de minimis" test or "control" test. If a nonprofit holds an interest in a pass-through entity and the nonprofit's ownership in that entity satisfies either of these tests, then the nonprofit can aggregate all investment income that it receives through that entity in one UBTI silo, even if those activities underlying the investment would otherwise be classified as separate trades or businesses under the NAICS two-digit codes. Investments in a pass-through entity that do not satisfy one of these tests must be categorized by UBTI silo based on the underlying activities of the entities and their corresponding two-digit NAICS codes. More information on the calculation and application of these tests is included both in the proposed regulations and Notice 2018-67.

3. Net Operating Losses and CARES Act Developments

The proposed regulations also clarify application of net operating losses (NOLs) incurred prior to enactment of the 2017 Tax Act (the pre-2018 NOLs) as well as NOLs arising in and after 2018 (post-2017 NOLs).

Pre-2018 NOLs are deducted from a nonprofit's total UBTI and may be used to offset 100% of UBTI arising in tax years prior to the 2107 Tax Act. In contrast, post-2017 NOLs may only be used to offset UBTI from the specific unrelated trade or business "silo" that generated the NOL, and is limited to 80% of UBTI for that silo. As a result, nonprofits should first utilize their pre-2018 NOLs to offset UBTI, which are more beneficial than the post-2017 NOLs.

Importantly, the recently enacted Coronavirus Aid, Relief, and Economic Security Act (CARES Act) temporarily repealed the 80% UBTI limitation for NOLs arising in taxable years beginning in 2020. This permits nonprofits with NOLs in tax years 2018-2020 to retroactively apply the NOL to the five years preceding the NOL. This can result in a tax refund for nonprofits who paid unrelated business tax in those years.

4. Other Key Provisions

The proposed regulations include several other nuanced rules regarding computation of UBTI and its effect on other rules applicable to tax-exempt organizations.

- **Debt-Financed Income.** Under the proposed regulations, nonprofits generally may treat all UBTI from an organization's debt-financed property or properties as income from investment activities that may be aggregated with other investment activities, rather than income from a separately-identified trade or business. However, certain rental income is not subject to the debt-financed property rules, such as income from rental of real and personal property where more than fifty percent of the total rent received is attributable to the personal property, or where personal services are provided along with a space rental. In those instances, the exempt organization must identify such unrelated trade or business using the NAICS 2-digit code for real estate rental and leasing rather than including it among aggregated "investment activities."
- **Public Support Test.** Some 501(c)(3) organizations are classified as public charities rather than private foundations because they demonstrate that they receive financial support from a broad sector of the public. This calculation is generally referred to as the "public support test." Under the proposed regulations, the public support test will consider a nonprofit's total aggregated UBTI rather than siloed UBTI. This is because applying the silo rules may unintentionally increase a nonprofit's amount of total support (i.e. the denominator of the public support test) if the losses from one trade or business cannot offset revenues from another.
- **Allocation of Overhead Expenses.** The IRS states in the proposed regulations that it intends to issue additional proposed regulations regarding how to allocate overhead expenses between trades or businesses. Until such guidance is released, nonprofits are permitted to use any reasonable method to allocate general overhead expenses among UBTI "silos."
- **Charitable Contributions.** Nonprofits that are subject to tax by virtue of earning UBTI can reduce that tax liability by making charitable contributions to other qualified charitable organizations. The proposed regulations state that the amount of a charitable contribution deductions will be applied to the nonprofit's total UBTI from all unrelated activities.



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If you have any questions on the UBTI siloing regulations or the calculation or reporting of income or expenses from nonprofit unrelated trades or businesses, please contact Catie Bitzan Amundsen, Greg Larson, Health and Nonprofit Organizations Practice Group Chair Jennifer Reedstrom Bishop, or your regular Lathrop GPM contact.