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Unrelated Business Income Tax Filings for 2018 Complicated by 2017 Tax Cuts and Jobs Act

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As the initial filing deadline for 2018 calendar year IRS Form 990-T filers approaches, the new rules that require separate calculation of income and deductions for each "trade or business" (including those operated through hedge funds and private equity partnerships) may merit more attention from sponsors of tax-exempt retirement plans, VEBAs, and SUB plans than in earlier years.

In this issue: New rule | What constitutes a separate trade or business? | Interim and transition rules for partnership investments | Parking, commuter benefits and on-premises athletic facilities added to UBTI | Changes to NOL rules | In closing

Background

Sections 511-514 of the Internal Revenue Code (Code) impose income tax on the unrelated business taxable income (UBTI) of tax-exempt entities for their regular operation of a trade or business that is not related to the organization's tax-exempt purpose. This tax is designed to level the playing field between tax-exempt entities that compete in the business world with their taxable counterparts so that they do not use their tax-exemption to unfairly compete with tax-paying entities.

In addition to affecting the nonprofit sector, these rules can result in income tax liability for the tax-exempt entities that are used to fund employee benefit plans on a tax advantaged basis: qualified retirement plan trusts, IRAs (including Roth IRAs, SEPs, SIMPLE IRAs, and Coverdell Education IRAs), Section 529 plans, HSAs, Archer MSAs, Voluntary Employee Benefit Associations (VEBAs), and Supplemental Unemployment Compensation Benefit Trusts (SUBs).

UBTI is defined as gross income derived by the tax-exempt entity from operating a "trade or business" that is not substantially related to the organization's tax-exempt purpose, less any deductions directly related to the trade or business that produced such income. UBTI also applies to unrelated debt-financed income (UDFI) of tax-exempt entities (i.e., income of a tax-exempt entity attributable to assets purchased with borrowed money).

For all the entities listed above, income from investments in entities that are structured as partnerships (e.g., publicly traded partnerships, master limited partnerships, and alternative investments — such as hedge funds or private equity funds) typically result in the trust receiving UBTI.

Generally, interest, dividends, and rents received by a tax-exempt entity are not considered UBTI. However, VEBA and SUB trusts are generally subject to unrelated business income tax (UBIT) based on a more inclusive definition of taxable investment income — including dividends, interest, and rents. In addition to deductions that are directly allocable to producing taxable investment income, such trusts can also exclude some reserves set aside for certain incurred but not reported claims for benefits that do not exceed the qualified asset account limit set forth in Code section 419A. (Collectively bargained or employee pay-all plans are not subject to this qualified asset account limit).

> **Buck comment**: One method that some tax-exempt entities use to avoid incurring UBIT and still participate in investment entities structured as partnerships (such as hedge funds and private equity funds) is to own shares in a "blocker" corporation instead. A blocker corporation is a C corporation set up to hold the partnership interests. To maximize tax efficiency, a blocker can be based in a country without a corporate income tax. Though a blocker may help a VEBA or SUB trust defer some otherwise taxable partnership income, any dividends paid by a blocker would be includible in its UBTI.

UBIT is reported and paid by filing IRS Form 990-T. For qualified retirement plan trusts, IRA-based plans and Archer MSAs, the initial 990-T deadline is the 15th day of the fourth month after the end of the entity's tax year (e.g., April 15 for calendar year filers). For all other entities required to file 990-T (including VEBAs and SUB plans), the initial due date is the 15 day of the fifth month after the end of the taxable year (e.g., May 15 for calendar year filers). Form 8868 can be filed to obtain an automatic six-month extension of these filing due dates, although this does not extend the date when the tax is due.

Prior to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA 2017), tax-exempt entities could offset income from one "trade or business" against losses incurred by other "trades or businesses" within the same taxable year.

Also, prior to TCJA 2017, the net operating loss (NOL) deduction allowed a net loss to be carried back up to two years and then carried forward up to twenty years. With carrybacks, the taxpayers could apply for a refund of the tax that was previously paid for that earlier year, and with carry-forwards, they could apply the loss to reduce or eliminate taxable income in later years.

Starting in 2018, new rules may result in higher taxation and more complicated reporting for tax-exempt entities

TCJA 2017 added section 512(a)(6) to the Code to provide that tax-exempt organizations that carry on more than a single unrelated trade or business must first determine UBTI separately for each unrelated trade or business. This includes for purposes of determining the NOL deduction, although NOLs from any trade or business for years beginning before January 1, 2018 can be carried over to reduce taxable income for any trade or business in later years. This means that income and deductions for unrelated trades or businesses may no longer be aggregated. A permitted $1,000 specific deduction is applied to the tax-exempt entity after all the UBTIs are calculated for all the trades or businesses — a loss in one trade or business can no longer offset UBTI from another.

In August 2018, IRS issued limited guidance under Notice 2018-67 to address these new rules.

The 2018 IRS Form 990-T now provides the new Schedule M for filers to complete for all trades and businesses after the first one. The UBTI shown for each trade or business on all Schedule M forms is then summed and incorporated in the main Form 990-T.

What constitutes a separate trade or business?

TCJA 2017 did not provide any guidance on this question. Until final regulations are issued, tax-exempt organizations can rely on a reasonable good faith interpretation, based on facts and circumstances, in determining whether an organization has more than one unrelated trade or business.

IRS will consider a taxpayer's use of the North American Industry Classification System 6-digit codes as an acceptable method for determining whether income from separate entities can be aggregated as a single trade or business.

> **Buck comment.** Since Form 990-T already asked for these codes to identity trades or businesses, this has been proposed as a sensible methodology. However, the decision to use a code (which was not necessarily pondered at great length by tax-exempt entities before) could now have unintended consequences that could lead to different income tax results.

In addition to being a separate trade or business, for most tax exempt entities, UBTI is only generated if the trade or business is not "related" to the entity's tax exempt purpose. Existing rules for tax-exempt organizations apply a "fragmentation principle" when making this determination. The fragmentation principle allows certain activities carried on primarily for the convenience of the organization's members, students, patients, officers or employees to not be considered a trade or business apart from the tax-exempt purpose of the organization. IRS regulations say that to be excluded from being considered an unrelated trade or business based on this principle, an activity must be casually but substantially related to the accomplishment of the tax-exempt organization's goals. For example, a hospital offering a cafeteria primarily for the convenience of its employees and patients would not cause the cafeteria to be considered an unrelated trade or business. However, if the cafeteria were open to the public and not primarily for employees and patients, that portion of the business might be an unrelated trade or business. IRS is considering using rules similar to this fragmentation principle for determining the silos needed for implementing the new separate trade or business rule.

> **Buck comment.** For qualified retirement plans, all trades or business are considered "unrelated." For this reason, examining the activities of the trade or business was not relevant prior to the TCJA 2017 change.

Since the UBTI rules allow an exempt organization to offset gross income with deductible expenses that are directly related to producing such income, the identification of expenses associated with different trades or businesses will now have heightened significance because such expenses cannot be offset against income from other trades or businesses. Shared expenses directly related to more than one trade or business can still be allocated among them in a reasonable manner, but IRS may issue guidance in the future on the expense allocation methods it deems reasonable. In particular, IRS recognizes the difficulty that will be presented for exempt organizations holding ownership interests in the nature of investments in entities that engage in multiple trades or businesses and multi-tiered partnerships because of this law change and intends to issue proposed regulations that will ease this burden.

> **Buck comment.** As noted above, VEBAs and SUB trusts are subject to tax on their UBTI that includes all investment income, not just partnership trade or business income. IRS Publication 598 clarifies that losses from nonexempt activities of these organizations cannot be used to offset investment income.

Interim and transition rules for partnership investments

Until proposed regulations are issued, if a tax-exempt organization owns a single partnership that is engaged in multiple trades or businesses (including trades or businesses of another partnership owned by that partnership), the tax-exempt organization can treat that partnership as operating a single trade or business if the exempt organization meets either the ***de minimis test*** or **the *control test***. In addition, these investment partnerships can be aggregated and treated as a single trade or business.

De minimis test

To meet the *de minimis* test, a tax-exempt organization must own no more than 2 percent of the profits interest and no more than 2 percent of the capital interest of the partnership. This must be measured using the figures reported in Part II of line J of the K-1 issued to the tax-exempt organization by the partnership, and by averaging the profits and capital interest held at the beginning or end of the partnership's taxable year — substituting the beginning or end of the ownership period for the beginning or end of the partnership taxable year if the partnership interest was acquired or disposed of during the partnership's taxable year.

Control test

To meet the control test, a tax-exempt organization must hold no more than a 20 percent capital interest in the partnership and exert no control or influence over it. The capital interest is determined in the same manner as the de minimis test above. The partnership would be controlled by the tax-exempt organization if the tax-exempt organization's officers, directors, trustees or employees can manage or conduct the partnership's business at any time, or appoint or remove any officer, director, trustee, or employee of the partnership.

For both the *de minimis* and the control test, the partnership interests held by disqualified persons (under the taxation of excess benefit transaction rules), supporting organizations (under the private foundation rules) or controlled entities are considered.

Transition rule

Tax-exempt organizations can treat each partnership interest acquired **before** August 21, 2018 (when Notice 2018-67 was issued) as if the partnership is a single trade or business — even if that partnership (or "lower-tier" partnerships owned by that partnership) carries on more than one trade or business.

Debt-financed income

If the interim or transition rules above are met, a tax-exempt organization may also aggregate unrelated debt-financed income with other income generated by the same partnership. Debt-financed income would arise, for example, where the exempt organization owns an interest in a hedge fund structured as a partnership that buys stocks with a margin loan and receives dividends from those shares or realizes a capital gain from selling them.

Parking, commuter benefits and on-premises athletic facilities added to UBTI

For tax-exempt organizations that offer qualified transportation fringe benefits or on-premise athletic facilities to their employees (or incur expenses for providing these benefits), these amounts are now added to UBTI in determining the taxable income of the tax-exempt organization (unless these benefits are directly connected to an unrelated trade or business that is regularly carried on by the tax-exempt organization, or are on-premises athletic facilities offered to a group of employees that are not primarily highly compensated). In Notice 2018-100, IRS announced that it would waive penalties for underpayment of estimated tax for tax-exempt entities who timely file IRS Form 990-T but were not required to file IRS Form 990-T in the previous year but have to do so now solely as a result of this change to the tax treatment of qualified transportation fringe benefits. In Notice 2018-99, IRS provided guidance to tax-exempt employers for determining the taxable amount of parking expenses that are includible in a tax-exempt organization's UBTI.

Changes to NOL rules

For NOLs generated in tax years beginning after December 31, 2017, TCJA 2017 eliminated the ability to carry back NOLs up to two years and removed the 20-year limit on carry-forwards. It also eliminated the ability to use an NOL from one trade or business to offset taxable UBTI from another trade or business. NOLs generated in pre-2018 tax years can still be carried back and carried forward to reduce UBTI in earlier or later tax years and can be applied to reduce UBTI generated from any trade or business.

When determining a NOL, the amount of the carry-back or carry-forward must be determined without taking income or deductions excluded in determining the UBTI into account. Also, for tax years starting in 2018 or later, the maximum NOL deduction for such years will be limited to 80 percent of taxable income as computed before the NOL deduction. IRS is considering whether some ordering rule will be required (such as applying all pre-2018 NOLs before applying post-2017 NOLs).

In closing

TCJA 2017 has introduced several changes that will make the determination of any UBIT (and reporting and paying that tax using IRS Form 990-T) more challenging. Though IRS has issued Notice 2018-67 to assist tax-exempt entities in complying with the changes, the guidance leaves considerable room for interpretation as many important questions are left unanswered. Sponsors of VEBAs and SUB plans who usually put off the filing IRS Form 990-T until right before the deadline (or the extended deadline) may want to leave some extra time for preparation this year to address questions that may arise with the help of their service providers — such as their filing preparer and legal or tax counsel.

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