LEGALcurrents®

October 3, 2018

Harter Secrest & Emery LLP

ATTORNEYS AND COUNSELORS

NOT-FOR-PROFIT ORGANIZATIONS

IRS ISSUES UBIT SILOING GUIDANCE

Authors: Joshua E. Gewolb, Anne F. Downey, Vittoria L. Buzzelli

While exempt organizations are, by definition, exempt from tax, they are subject to a tax on their income from unrelated businesses.

The Tax Cuts and Jobs Act ("the Act") makes significant technical changes to the computation of unrelated business income tax (UBIT). Specifically, if an organization has more than one unrelated trade or business, the Act provides that deductions from one business may not offset income from another business. This would increase tax on organizations that make money in one unrelated line of business but lose money in other unrelated lines of business.

For example, consider a hospital that operates a lab accepting specimens from private practices. The hospital invests in an oil and gas partnership. The oil and gas partnership loses money, but the lab makes money. Losses from the oil and gas partnership cannot be used to offset gain from the lab.

This change is estimated to generate $3.2 billion in revenue over ten years.

When these rules were enacted, there were many unanswered questions about their operation. The central questions relate to how to define "trade or business" and what constitutes having more than one "trade or business." In particular, practitioners questioned whether all investment activities, particularly those engaged in through passthrough entities, constitute a single silo.

Last month, the IRS issued Notice 2018-67, which provides temporary guidance on some of the issues Congress left unresolved. The notice can generally be relied on until issuance of the proposed regulations.

Identifying a "Trade or Business"

The notice generally failed to answer the question of when a separate trade or business exists, stating that the IRS is studying the issue.

Pending further guidance, exempt organizations can rely on a reasonable, good-faith interpretation of the existing UBIT rules to make the determination of what constitutes a separate trade or business considering all the facts and circumstances. The IRS seemed to be floating a methodology focused on the North American Industry Classification System (NAICS) codes and stated that use of the 6-digit NAICS code is a permissible method. In making this point, the IRS noted that the UBIT return (Form 990-T) already requires the use of 6-digit NAICS codes. The IRS also noted that exempt organizations may want to consider fragmentation principles (relating to identification of separate trade or businesses within a larger aggregate of similar activities), in determining their compliance with the above.

With respect to future guidance, the IRS stated that it has considered various other code sections that identify trades or businesses and is concerned that they are not useful models for UBIT purposes. The IRS also expressed its concern that a facts and circumstances test would be impossible to administer for taxpayers and for the service on audit. For these reasons the IRS noted its consideration of the use of NAICS

codes and its interim rule stating that these codes may be relied on. The IRS is soliciting comments from taxpayers on these issues.

"Trade or Business" for Investment Activities

The notice provides detailed guidance on when investments in partnerships can be aggregated for the siloing rules. This topic has been a cause of concern within the exempt organization community, particularly as it relates to investments by exempt organizations in private equity funds and other pooled investment vehicles. The IRS clearly heard these concerns. The guidance sets forth two different rules, the Interim Rule and the Transition Rule, that taxpayers can rely upon prior to the issuance of additional guidance, and which vastly simplify these complex areas—at least for now.

Interim Rule

Under the Interim Rule, all qualifying partnership interests can be aggregated and treated as a single trade or business. This includes lower-tier partnerships.

A partnership interest is a "qualifying partnership interest" under either the *de minimis* test or the control test.

Under the *de minimis* test, a partnership interest is a qualifying partnership interest if the exempt organization holds no more than 2% of the profits interest and 2% of the capital interest.

Exempt organizations can rely on the average interest in the partnership shown on Schedule K-1 (Part II, Line J) to determine the percentage for these purposes.

Under the control test, a partnership interest is a qualifying partnership interest if the exempt organization holds no more than 20% of the capital interest and does not have control or influence over the partnership. Understanding the precise meaning of control or influence is a key question, for example, when partners serve on advisory boards related to investment funds.

While fund investments should generally meet one of these tests, a potential problem is presented by co-investments. Organizations may need to tweak the way they approach co-investments in connection with investment partnerships to address this concern.

For both the *de minimis* and control tests, the exempt organization's partnership interests are aggregated with any supporting organization, disqualified person or controlled entity. The inclusion of supporting organizations is particularly interesting. This appears to have been designed contemplating a single supporting organization for the exempt organization. However, its application may generate unintended results where there are multiple supported charities, or the supporting charities are described by class.

Transition Rule

Separate from the Interim Rule, the guidance provides for a Transition Rule. Under this Rule, until publication of further guidance, exempt organizations can treat a single partnership interest acquired before August 21, 2018 as a single trade or business regardless of whether the partnership (or any lower-tier partnership) directly or indirectly conducts multiple trades or businesses.

However, unlike the Interim Rule, multiple partnership interests qualifying under the Transition Rule ***cannot*** be aggregated to treat the aggregate group of partnership interests as a single trade or business.

Other Matters

In addition to the above, the notice addressed a number of other difficult problems relating to UBIT siloing that have vexed practitioners. With respect to partnerships, it stated that debt-financed income is aggregated with other partnership income. Guidance is not provided on debt-financed income outside of the partnership context; however, the IRS explores this issue in the notice and requests comments.

In addition, the notice clarifies that transportation and parking fringes are not subject to the siloing rule. Finally, the notice confirms that NOLs in years before January 1, 2018 may be used without siloing.

Potential Strategy

One strategy that exempt organizations may wish to consider in light of the new rules is the formation of a taxable subsidiary to conduct unrelated businesses. For a taxable organization, unlimited offset across lines of business is permitted. However, there are a number of disadvantages to this approach. For example, liquidation can give rise to a deemed income event, 100% of debt-financed income is subject to tax, and prior carryforwards cannot be used for the contributed business. In addition, use of a for-profit subsidiary may not present the desired optics for institutions that like to conduct business in their own name. We advise delaying action until final guidance is issued.

If you have questions about these rules, contact any member of our Not-for-Profit Organizations practice group at 585.232.6500, or for more information visit www.hselaw.com.

Joshua E. Gewolb, 585.231.1151, jgewolb@hselaw.com
Anne F. Downey, 716.844.3768, adowney@hselaw.com
Vittoria L. Buzzelli, 585.231.1361, vbuzzelli@hselaw.com