IRS Proposes UBIT "Silo" Rules for Nonprofits

Proposed rules aim to make things easier for you if your organization owns businesses or certain investments.

By Yossi Ziffer & Chris Moran

The Internal Revenue Service (IRS) has just released some long-awaited guidance for nonprofits. Proposed regulations, issued on April 23, 2020, explain how nonprofits with unrelated businesses or certain investments should calculate their unrelated business taxable income (UBTI).

Background on Proposed Regulations

Historically, nonprofits measured their UBTI, and thus determined their unrelated business income tax (UBIT) liability, on an aggregated basis. For example, until recently, you could have applied costs incurred in connection with the sale of advertising against the gross income generated from a food service business, thereby aggregating all your sources of revenue and related expenses in computing the total net tax liability at the organizational level.

But that changed a few years ago. Section 512(a)(6) of the IRS Code, amended as part of the 2017 Tax Cuts and Jobs Act, introduced a new UBIT "silo" concept. These silo rules require nonprofits with more than one unrelated trade or business to calculate UBTI separately for each trade or business.

The IRS released temporary guidance in 2018 (Notice 2018-67), directing organizations to rely on a "reasonable, good-faith interpretation" of Code Sections 511 through 514 to determine separate trades and businesses. One "reasonable" method the IRS identified was to use the 6-digit codes of the North American Industry Classification System (NAICS) to designate industry groups.

The problem with that method was that the NAICS 6-digit codes separate trades or businesses into more than 1,000 industry groups. Defining businesses into that much detail would have placed a huge administrative burden on nonprofits and, by extension, the IRS.

> "The IRS is making it easier for nonprofits that run businesses."

For that reason, the proposed regulations instruct nonprofits to use 2-digit instead of 6-digit NAICS codes. The 2-digit codes separate trades or businesses into only 20 different economic sectors such as retail trade, educational services, and so on. By using those broader classifications, the IRS is making it easier for nonprofits that run businesses to determine which code applies and to administer the rules.

Key Issues Addressed by the Proposed Regulations

SEPARATE UNRELATED TRADES OR BUSINESSES

The new proposal of using 2-digit codes (discussed above) reduces your administrative burden if your organization has multiple trades or businesses. Furthermore, the use of 2-digit codes lets you combine broadly similar activities when computing UBTI. Thus, you can offset income from one activity with losses from another activity classified within the same broad sector.

INVESTMENT ACTIVITIES

In another key part of the regulations, the IRS describes exceptions to the silo rules for specific investment activities. The regulations allow you to combine UBTI-generating investment activities that satisfy either a "de minimis" test or a "control" test.[1] (See the next section for definitions of these tests).

If your organization holds an interest in a pass-through entity (such as a partnership, limited liability company, or S corporation), and the extent of your ownership satisfies either the de minimus or control test, then you may aggregate all UBTI that you receive through that pass-through entity – even if those activities would otherwise constitute multiple trades or businesses under the 2-digit codes.[2]

Moreover, if your organization holds qualifying interests in multiple pass-through entities engaged in various unrelated businesses, you may aggregate those pass-through interests as a single business. Thus, all UBTI gains and losses flowing through these interests would be reported together as from a single trade or business. [3]

Conversely, what if your organization holds an investment interest in a pass-through entity but the interest doesn't

> "You can obtain a refund of some or all of the UBIT you paid."

satisfy either the de minimis or control test? Then you'll need to classify the UBTI you receive based on the activities of the pass-through entity, which could result in reporting multiple trade and business categories.

What Is the De Minimis Test?

Your organization satisfies the de minimis test if you hold directly no more than 2% of the profits and no more than 2% of the capital interest (2% of the stock in the case of interest in an S corporation) in a pass-through entity.[4]

For purposes of the de minimis test, the regulations omit the rule that would have required you to include interests held by board members, other related persons, "supporting organizations," or controlled entities.[5] Rather, as long as the interests held directly by your organization don't exceed the 2% thresholds, you'll satisfy the de minimis test.

What Is the Control Test?

The control test is satisfied if your organization:

(1) directly holds no more than 20% of the capital interest (20% of the stock in the case of interest in an S corporation) in a pass-through entity *and*

(2) doesn't have control or influence over the pass-through entity's decision-making.[6]

All facts and circumstances, including the terms of the governing documents of the investment entity, are relevant for determining whether your organization has control or influence.[7]

To determine if your organization's ownership interest exceeds 20%, the interests held by "supporting organizations" or entities controlled by your organization are combined with your organization's interest.[8] However, you needn't consider interests held by board members and other related persons when determining your organization's ownership interest.[9]

What Is the Look-Through Rule?

The proposed regulations also provide a new "look-through" rule for nonprofits that hold indirect interests in lower-tier partnerships. If your organization doesn't control a partnership in which it holds a direct interest of more than 20%, any lower-tier partnership in which your organization holds an indirect interest of no more than 2% will satisfy the de minimis test.[10]

For example, if your organization holds 50% of the capital interest of partnership X and your organization doesn't control partnership X, *and* partnership X in turn holds 4% of the capital and profits interest of a lower-tier partnership Y, your organization's interest in partnership Y will be deemed to satisfy the de minimis test (because 50% of 4% = 2%). Thus, any UBTI flowing from partnership Y to your organization will be eligible for the reporting rules for investment activities.

Can You Rely on K-1 Schedules?

K-1 Schedules can be useful in measuring your organization's ownership interest in a pass-through entity to decide if you're eligibile for the de minimis or control exception. You can often determine your percentage interest in the pass-through entity by relying on the ownership percentage listed on the K-1 Schedule you receive from the entity.[11]

However, not all K-1 Schedules contain enough detail for you to measure your ownership interest. Thus, you must use other sources to determine your ownership percentage if the K-1 Schedule:

- **doesn't list** your organization's ownership interest, or
- **lists the interest** as "variable."[12]

What Is the Transition Rule?

Notice 2018-67 provided a transition rule permitting you to treat each partnership interest acquired before August 21, 2018 (the date Notice 2018-67 was published) that didn't meet the requirements of either the de minimis or control test as one business for purposes of the silo rules, regardless of whether the partnership or lower-tier partnerships conducted more than one business.[13]

The proposed regulations state that the transition rule ends on the first day of your organization's tax year beginning after final regulations are published.

ALLOCATION OF EXPENSES

The IRS plans to issue additional guidance regarding how you should allocate expenses connected with one or more businesses, including both your organization's core exempt activities and its unrelated businesses.

Until the IRS issues this guidance, you may allocate such expenses using any reasonable method.[14]

DEBT-FINANCED INCOME

The regulations allow you to disregard debt financing when evaluating whether a stream of income must be separately "siloed." Thus, for example, if your organization earns passive income (such as interest, dividends, or rental income from real property) that's subject to UBIT because it's debt-financed, you may group that income with other investment income subject to UBIT.[15]

However, if the income from your organization's debt-financed property would be treated as UBTI even if it weren't debt-financed, then you must treat it as income from a separate unrelated business and use the 2-digit codes to identify it.[16]

For example, if your organization uses debt financing to purchase property and leases the property in exchange for rental income based on a percentage of the lessee's net profits, you must identify the leasing business using the 2-digit codes, because the rental income would be UBTI regardless of the debt-financing rules.[17]

CHARITABLE CONTRIBUTIONS

One way you can reduce the amount of UBTI you must pay is by making tax-deductible charitable contributions.[18] Rather than allocating these deductions among your unrelated businesses, the regulations allow you to take your charitable deductions against your total UBTI (i.e., after you have computed all "silo" amounts and calculated your preliminary tax liability).[19]

NET OPERATING LOSSES (NOLS)

The regulations clarify that you may apply "grandfathered" NOLs from tax years before the 2017 Tax Act ("pre-2018 NOLs") against your UBTI first, before your NOLs from tax years after the 2017 Tax Act ("post-2017 NOLs").[20] You may use your pre-2018 NOLs to offset 100% of UBTI. They'll be deducted from your total UBTI.

By contrast, the deduction available for post-2017 NOLs is limited to 80% of UBTI, and you may use it to offset only UBTI arising from the unrelated trade or business "silo" that generated the NOL.

Pre-2018 NOLs expire after 20 years, while post-2017 NOLs may be carried forward indefinitely. By clarifying that pre-2018 NOLs can be used before post-2017 NOLs, the proposed regulations let you maximize use of your pre-2018 NOLs, which are more useful than post-2017 NOLs.

A Quick Run-Down of Key Terms & Acronyms

CARES Act: the Coronavirus Aid, Relief, and Economic Security Act of 2020, which offers tax relief for some nonprofits with unrelated businesses

Carryback: A loss that you don't report now but instead deduct from taxable income from a previous year; when you carry back an NOL, you must recompute your new tax liability in that year by taking into account the NOL deduction

Control test: the IRS tax rule that gives a percentage you can use to decide if your organization has control or influence over an investment entity; this percentage determines how you'll report your unrelated businesses

De minimus test: tax rule that gives a threshold you can use to decide whether you can combine UBTI-generating investment activities

K-1 Schedule: an IRS tax form issued annually for an investment in partnership interests; the purpose of the K-1 Schedule is to report each partner's share of the partnership's earnings, losses, deductions, and credits

NAICS: North American Industry Classification System; its 6-digit codes divide businesses into over a thousand types, while its 2-digit codes classify businesses into only 20 types; the new IRS rules propose that nonprofits use the 2-digit codes to categorize their unrelated businesses (rather than the 6-digit codes proposed in Notice 2018-67)

NOL: net operating loss (a tax credit that occurs when tax deductions of a business are more than its taxable income in a year; this loss is carried forward to offset future profits, thus reducing the business's tax liability)

Notice 2018-67: a temporary IRS directive published in 2018; the proposed 2020 rules modify that directive

Pass-through entity: a legal entity such as a partnership that passes income on to investors so that the investors rather than the entity are taxed; businesses commonly use pass-through entities (also known as flow-through entities) to reduce the amount of taxes they must pay; the IRS doesn't tax pass-through entities but does require them to file an annual K-1 Schedule

Post-2017 NOLs: NOLs from tax years after the 2017 Tax Act

Pre-2018 NOLs: NOLs from tax years before the 2017 Tax Act

S corporation: a type of corporation to which the IRS gives the benefit of incorporation while taxing it as a partnership

Silo rules: rules stating that nonprofits with more than one unrelated business must calculate UBTI separately for each of those businesses; these rules went into effect on January 1, 2018

Supporting organization: a charity that carries out its exempt purposes by supporting other exempt organizations, usually other public charities

Tax Act: the 2017 Tax Cuts and Jobs Act (also known as the Tax Act or TCJA), passed in December 2017; among many changes to the IRS Code, this Act reduced tax rates for businesses and individuals

UBIT: unrelated business income tax; a nonprofit is required to pay UBIT if it runs a business that isn't related to its mission

UBTI: unrelated business taxable income (the money a nonprofit receives from running a business that's not related to its mission)

In the wake of the current COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) temporarily repealed the 80% UBTI limitation for NOLs arising in taxable years beginning in 2020, thus increasing the economic utility of certain post-2017 NOLs.[21]

Furthermore, the CARES Act permits nonprofits with NOLs arising in 2018, 2019, and 2020 to "carry back" the NOL to each of the five years preceding the NOL. You can thus obtain a refund of some or all of the UBIT you paid in those years.[22]

Since NOLs are carried back to the earliest year in which the organization paid UBIT, some nonprofits will have the opportunity to carry back NOLs arising in 2018, 2019, and/or 2020 to tax years in which the silo rules didn't apply (i.e., pre-2018 tax years).

On June 8, 2020, the IRS issued a set of FAQs detailing how the UBIT silo rules interact with the temporary revival of NOL carrybacks under the CARES Act.[23] The FAQs clarify that nonprofits may carry back an NOL arising in 2018, 2019, and/or 2020 and deduct it against aggregate UBTI in a taxable year beginning before January 1, 2018 (i.e., before enactment of the silo rules).

A Brief Summary of the Proposed Regulations

A key benefit of these rules is that you'll be able to use 2-digit rather than 6-digit NAICS codes to classify your unrelated trades or businesses. The use of 2-digit codes:

- **eases your workload** because there are only 20 industry groups (rather than over 1,000 groups with the 6-digit codes), making it simpler to decide which code applies
- **gives you greater leeway** to offset income from one unrelated business with losses from another if the two businesses are within the same broad industry group.

In addition, the proposed rules:

- **let you use pre-2018 NOLs** to offset 100% of your UBTI
- **limit the conditions** in which you must combine your organization's ownership interest with interests held by related persons or entities
- **allow you to make charitable gifts** as a way of offsetting your UBTI liability.

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UBIT, Taxes, the IRS, & You

For more on unrelated business income tax and other IRS matters, see these articles at NonprofitWorld.org:

Are Your Activities Safe from UBIT? (Vol. 16, No. 5)

IRS Audits: What Could They Mean for Unrelated Business Income? (Vol. 35, No. 3)

The IRS 990 Return: It's More Important Than You Think (Vol. 16, No. 2)

New Act & Ruling: What Are the Fundraising Repercussions? (Vol. 15, No. 1)

The Compliant, Unaccountable Nonprofit or How to Not Be Accountable, While Remaining Compliant with IRS Disclosure Rules (Vol. 18, No. 4)

The Biggest Audit Mistakes Nonprofits Make & How to Avoid Them (Vol. 37, No. 1)

UBIT: What It Is & How to Avoid It (Vol. 13, No. 4)

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New Excise Tax: How Will It Impact Nonprofits? (Vol. 37, No. 2)

How to Find the Perfect Auditor (Vol. 22, No. 3)

FOOTNOTES

[1] Prop. Reg. 1.512(a)-6(c)(3), (4)

[2] Prop. Reg. 1.512(a)-6(c)(1)(i)–(ii)

[3] Id.; 85 Fed. Reg. 23172, 23179–80

[4] Prop. Reg. 1.512(a)-6(c)(2)(i), (ii), (3)

[5] 85 Fed. Reg. 23172, 23180

[6] Prop. Reg. 1.512(a)-6(c)(4)(i), (iii)

[7] Prop. Reg. 1.512(a)-6(c)(4)(iii)(A)–(D)

[8] Prop. Reg. 1.512(a)-6(c)(4)(ii)

[9] 85 Fed. Reg. 23172, 23181

[10] Prop. Reg. 1.512(a)-6(c)(2)(ii)

[11] Prop. Reg. 1.512(a)-6(c)(5), (e)(2)(ii)

[12] Prop. Reg. 1.512(a)-6(c)(5)

[13] Notice 2018-67, Sec. 6.04

[14] Prop. Reg. 1.512(a)-6(f)

[15] Prop. Reg. 1.512(a)-6(c)(1)(iii)

[16] 85 Fed. Reg. 23172, 23184; Code Section 514(b)(1)(B)

[17] Code Section 512(b)(3)(B)(ii); Reg. 1.512(b)-1(c)(2)(iii)(b)

[18] Code Section 512(b)(10), (11)

[19] 85 Fed. Reg. 23172, 23189

[20] Prop. Reg. 1.512(a)-6(h)(2)

[21] P.L. 116-36, 134 Stat. 281, Sec. 2303(a)

[22] Code Section 172(b)(1)(D)(i)(I)–(II), as amended by P.L. 116-36, 134 Stat. 281, Sec. 2303(b)

[23] FAQs – Carryback of NOLs by certain exempt organizations (June 8, 2020)