Guidance on UBTI Allocations Allows 'Good Faith' Interpretations

by Fred Stokeld

Tax-exempt organizations can rely on a "reasonable, good-faith interpretation" to determine whether they have multiple unrelated trades or businesses when trying to calculate unrelated business taxable income, the IRS said in August 21 guidance.

The agency said in Notice 2018-67, 2018-36 IRB 1, addressing section 512(a)(6), that instead of a facts and circumstances test, the IRS will consider use of a North American Industry Classification System (NAICS) six-digit code to be a reasonable and good-faith interpretation before it issues its proposed regulations on the new provision.

The initial guidance on calculating UBTI in response to changes made by the Tax Cuts and Jobs Act (P.L. 115-97) is a first step in providing needed answers for tax-exempt organizations, although at least one nonprofit representative said the IRS should have postponed implementation of section 512(a)(6) to give nonprofits immediate relief from the tax as well as time to adjust their accounting systems and train employees.

> ***While reliance on the NAICS code standard is a good start, it isn't a solution, Thompson said.***

David L. Thompson of the National Council of Nonprofits called it "unfortunate and troubling" that the IRS didn't delay implementation of section 512(a)(6), which he said unfairly treats nonprofit business activities differently from those of for-profits.

While reliance on the NAICS code standard is a good start, it isn't a solution, Thompson said. "Many types of rental income, for instance, would be broken into unworkable groupings that effectively treat the use of the same facilities as multiple 'trades or businesses' and, due to accounting and tax costs, discourage facility use," he said.

Directly Connected Deductions

Regarding the allocation of directly connected deductions under section 512(a)(1), the IRS and Treasury said they might modify the underlying reasonable allocation method outlined in existing regs and provide standards for allocating expenses related to dual-use facilities and section 512(a)(6).

The notice also acknowledged that section 512(a)(6) could burden organizations required to treat unrelated debt-financed income, specified payments from controlled entities, and some insurance income as UBTI. Therefore, aggregating income included in UBTI under those categories may be appropriate in some circumstances, the IRS said.

And to address any burdens that section 512(a)(6) might impose on organizations with investments, the IRS and Treasury intend to treat some exempt organization investment activities as one trade or business so that organizations can aggregate gross income and directly connected deductions from those activities.

An interim rule in the notice permits aggregation of qualifying partnership interests that satisfy either the de minimis test or control test into one trade or business. Also, a transition rule allows for aggregating income within each direct partnership interest acquired before August 21.

That transition rule is the "brightest" part of the notice, and it proves that the IRS and Treasury have the authority to relieve nonprofits of immediate and burdensome tax liabilities, Thompson said.

Because social clubs, voluntary employees' beneficiary associations, and supplemental unemployment compensation benefits trusts are taxed differently under section 511, the IRS and Treasury are seeking comments on how section 512(a)(6) should apply to those entities, particularly regarding their investment income.

Notice 2018-67 also says fringe benefits considered UBTI under the section 512(a)(7) transportation fringe benefit tax are not income for purposes of section 512(a)(6). Churches and other nonprofits will be pleased that they can offset section 512(a)(7) with losses from any source, said Alexander L. Reid of Morgan Lewis & Bockius LLP. "This should allow many organizations to zero out their parking tax with a bit of tax planning," Reid said. Also, inclusion of global intangible low-taxed income under section 951A(a) will be treated as a dividend generally excluded from UBTI.

Meghan Biss of Caplin & Drysdale Chtd. called the notice comprehensive and said the IRS "has demonstrated a real willingness to understand the significant burden this section places on organizations and attempts to create guidance with that burden in mind."

"Although there are a number of areas where they are still seeking comments, such as net operating losses, this guidance is a positive step in providing organizations with some framework to use while regulations are pending," Biss said. ■