CLIENT ALERT

PROPOSED REGULATIONS ISSUED REGARDING UBTI "SILO" RULES

The Treasury Department and Internal Revenue Service ("IRS") have issued proposed regulations regarding the unrelated business income tax ("UBIT") that is imposed on tax-exempt organizations which have unrelated business taxable income ("UBTI") in connection with more than one unrelated trade or business. The proposed regulations provide guidance on identifying separate trades or businesses, including investment activities, each referred to as a "silo," and related matters.

Unrelated Business Taxable Income

An exempt organization is not required to pay tax on income from activities, including the operation of a trade or business, if those activities relate to the organization's exempt purpose. Exempt organizations are, however, subject to tax on their unrelated business income, or income derived from a trade or business that is not substantially related to the accomplishment of an exempt purpose. UBIT is calculated pursuant to Section 512 of the Internal Revenue Code (the "Code"), which lists exceptions and deductions applicable to an exempt organization's unrelated business income. The amount of unrelated business income that is subject to tax after deducting amounts for expenses directly associated with the trade or business is UBTI.

Under prior law, UBTI was the gross income of all unrelated trades or businesses less the allowed deductions from all unrelated trades or businesses. This meant that exempt organizations with more than one unrelated trade or business determined UBIT liability by aggregating income and expenses from all unrelated trades or business. This changed, however, with the enactment of the 2017 Tax Cuts and Jobs Act ("TCJA"). Section 512(a)(6) of the Code, which was added as part of the TCJA and applies to tax years beginning after December 31, 2017, provides that tax-exempt organizations with more than one unrelated trade or business must now calculate UBIT liability for each trade or business separately.

Proposed Regulations

The proposed regulations answer a number of questions raised by Section 512(a)(6), including:

What is a "separate" trade or business? The proposed regulations generally require organizations to categorize trades or businesses according to the first two digits of the six-digit North American Industry Classification System ("NAICS") Codes that most accurately describe each trade or business. The NAICS Codes classify trades and businesses into twenty sectors designated by the first two digits of the NAICS Code, further subcategorizing those sectors with increasing specificity using the remaining digits. Previous guidance issued by the Treasury Department and IRS had indicated that the six-digit NAICS Code might be used to categorize trades and businesses in separate categories, or silos. By categorizing uses only by the first two digits of the NAICS Codes, the proposed regulations permit broad identification of trades or businesses, allowing aggregation of profits and losses for activities that fall within the same 2-digit NAICS Code. This is true even where an organization operates multiple facilities that maintain separate books and records. As long as the activities fall within the same 2-digit NAICS Code, the income and losses for the activities may be aggregated for purposes of calculating UBIT liability.

An organization may not, however, describe all of its activities by reference to the 2-digit NAICS Code that describes the organization's exempt function. For example, a hospital that generates UBTI from medical testing services and the operation of multiple pharmacies may not use the NAICS Code for health care to encompass all of its activities; however, it may aggregate all of the pharmacies together under the NAICS Code for retail trade.

How are investment activities classified? The proposed regulations define what activities constitute "investment activities" and clarify that the activities falling with this definition are treated collectively as a separate trade or business. Investment activities include unrelated debt financed income, such as rental income derived from real property acquired with debt-financing that is leased to unrelated third parties. However, if income derived from debt-financed property would be treated as UBTI even if it were not debt financed (such as rental arrangements that include the provision of services), the income is treated as a separate trade or business that must be identified using the NAICS 2-digit Codes.

Investment activities also include certain interests in pass-through entities (such as partnerships, LLCs and S corporations) that meet either a "de minimis" or "control" test. In short, if an organization holds an interest in a pass-through entity and its interest satisfies either of these tests, the organization may aggregate the UBTI those interests generate even if those activities would otherwise be described by different NAICS Codes. If the organizations do not satisfy either test, the activity must be classified according to the NAICS Code for the activities conducted by the pass-through entity. Special rules apply to indirectly held interests in pass-through entities.

How are net operating losses treated? Net operating losses ("NOLs") from tax years prior to enactment of the TCJA may be applied before NOLs arising in subsequent years, and may be used to offset up to 100% of UBTI. NOLs from years prior to the TCJA expire after twenty years. Going forward, the deduction for NOLs is limited to 80% of total UBTI and must be applied to the trade or business that generated the NOL, but may be carried forward indefinitely. Note, however, that the Coronavirus Aid, Relief, and Economic Security Act has made certain temporary changes to the NOL rules, including a temporary repeal of the 80% deduction limit. The IRS has not yet issued guidance on the temporary rule changes.

How are overhead costs allocated? The IRS did not issue guidance as to how overhead costs should be allocated between separate trades or businesses but indicated that such guidance will be forthcoming in the future. In the meantime, organizations may use any reasonable method to allocate such costs. However, the proposed regulations make clear that an unadjusted gross-to-gross method, in which allocations are made on the basis of a ratio of gross income from the unrelated trade or business activity to all organizational income is not a reasonable allocation method. Instead, the allocation method adopted by an organization must include adjustments for the portion of expenses attributable to the unrelated business activity in order to be reasonable.

How do the silo rules interact with the public support test? Many organizations which are tax exempt under section 501(c)(3) (publicly supported organizations) must annually calculate the amount of support they receive in the form of public support. The proposed regulations allow such organizations to aggregate net income and net losses from all UBTI generating activities for the purpose of calculating public support.

Can an organization reduce its UBTI through charitable contributions? Organizations may reduce UBIT liability by making charitable contributions. Deductions for charitable contributions are not allocated to separate trades or businesses, but are taken against the total tax owed.

If you have any questions about the proposed regulations, or UBTI more generally, please contact Attorneys Elka Sachs, esachs@kb-law.com, or Eric Reustle, ereustle@kb-law.com.