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Unrelated Business Income under the Tax Cuts and Jobs Act

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Topics to be Covered

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- Overview of section 512(a)(6) and IRS Notice 2018-67
- Identifying separate trades or businesses
- Allocation of directly connected deductions
- Income from investment partnerships
- Net operating losses
- Fringe benefits
- Other



Polling Question #1

What aspect of unrelated business taxable income (UBTI) under the Tax Cuts and Jobs Act causes you the most concern?

- A. Identifying separate trades or businesses
- B. Inclusion of parking / transportation fringes as UBTI
- C. Tracking / utilizing net operating losses (NOLs)
- D. Investment analysis
- E. All of the above



Overview of Section 512(a)(6) and IRS Notice 2018-67

UBTI Separately Computed for Each Trade or Business

According to section 512(a)(6) added by the Tax Cuts and Jobs Act:

- If a tax-exempt organization has more than 1 unrelated trade or business, UBTI must be computed separately with respect to each trade or business
- Any loss derived from one unrelated trade or business may not be used to offset income from another unrelated trade or business
- Corporate tax rate is now 21%
- Applies to tax years beginning after December 31, 2017.

What's New – IRS Notice 2018-67

- Released August 21, 2018
- Discusses and solicits comments regarding various issues arising under section 512(a)(6)
 - Identifying separate trades or businesses
 - Allocation of directly connected deductions
 - Income from investment partnerships
 - Calculating net operating losses
 - Fringe benefits
 - Other
- Sets forth interim guidance and transition rules

General Impressions of IRS Notice 2018-67

- Before delving into the details of UBIT siloing and IRS Notice 2018-67, where do we stand now?



Identifying separate trades or businesses

Identifying separate trades or businesses

- Congress did not provide criteria for determining whether an exempt organization has more than one unrelated trade or business or how to identify separate unrelated trades or businesses
- Exempt organizations may rely on a reasonable, good-faith interpretation of the law
- NAICS 6-digit codes
- Other methods
 - Fragmentation principle
 - Revenue rulings
 - Sections 132, 162, 183, 414, 469
- Facts-and-circumstances test – Treasury and IRS would like to set forth a more administrable method than a facts-and-circumstances test alone

Identifying separate trades or businesses

Practical considerations:

- Is reporting centralized or decentralized within the institution?
- Which internal department oversees and tracks the subject activity?
- Compare NAICS codes to current or prospective silos—consider whether NAICS codes may be broader than anticipated and may actually simplify reporting.

Polling Question #2

How many separate unrelated trades or businesses does your organization have?

- A. 0 – 1
- B. 2 – 4
- C. More than 4
- D. I don't know or not applicable



Allocation of directly-connected deductions

Allocation of directly-connected deductions

- To be “directly connected” with a trade or business, an item of deduction must have a proximate and primary relationship to the carrying on of the unrelated trade or business generating the gross income
- Dual-use facilities – expenses, depreciation, and similar items attributable to such facilities must be allocated between the two uses on a reasonable basis (see IRS Priority Guidance Plan)
- The same allocation issue applies under section 512(a)(6), in that exempt organizations with more than one unrelated trade or business must not only allocate indirect expenses among exempt and taxable activities, but also among separate unrelated trades or businesses
- IRS and Treasury are requesting comments regarding possible rules or defined standards for allocation of indirect expenses

Allocation of directly-connected deductions

Practical considerations:

- When federal grants are involved, internal recordkeeping related to expense allocation necessarily may be more detailed.
- Are gross charges the same regardless of who receives the service (student/non-student; patient/non-patient; member/non-member)?
- Rensselaer ... yes or no? Whether to apportion on the basis of actual hours used (rather than hours available for use).

Income from investment partnerships

Income from investment partnerships

- Exempt organizations feared that the activities within investment partnerships (such as a multi-tiered partnership) would have to be separated under section 512(a)(6)
- Aggregation permitted ... AS LONG AS the directly held interest meets either of two tests – a “qualifying partnership interest”
 - De Minimis Test
 - Control Test

Reminder: 512(a)(6) applies to tax years beginning after December 31, 2017.

Income from investment partnerships (continued)

- De Minimis Test
 - Exempt organization holds directly no more than 2% of the profits interest and no more than 2% of the capital interest
 - May rely on Schedule K-1
 - Use average of the organization's percentage interest at the beginning and the end of the partnership's tax year (or beginning and end of period of ownership within the tax year)
 - Related interests are combined
 - When determining % partnership interest, the interest of a disqualified person, a supporting organization, or a controlled entity in the same partnership is taken into account

Income from investment partnerships (continued)

- De Minimis Test (continued)
 - Related interests are combined - example
 - Exempt organization owns 1.5% of profits interest in a partnership
 - Disqualified person owns 1% of profits interest
 - Combined ownership = 2.5% of profits interest
(de minimis test not met)
 - Who is a disqualified person?
 - Same meaning as section 4958(f)
 - In a position to exercise substantial influence over the affairs of the organization
 - Family member
 - 35% controlled entity

Income from investment partnerships (continued)

- Control Test
 - Exempt organization:
 - Directly holds no more than 20% of the capital interest; and
 - Does not have control or influence over the partnership
 - May require the partnership to perform, or prevent the partnership from performing, significant acts
 - Right to participate in management of the partnership or conduct partnership business
 - Power to appoint or remove partnership officers, directors, trustees, employees
 - May rely on Schedule K-1
 - Use average of the organization's percentage interest at the beginning and the end of the partnership's tax year (or beginning and end of period of ownership within the tax year)

Income from investment partnerships (continued)

- Transition rule – for partnership interests acquired prior to August 21, 2018, an exempt organization may treat each partnership interest as comprising a single trade or business for purposes of section 512(a)(6)

Income from investment partnerships (continued)

- Unrelated debt-financed income – the income from qualifying partnership interests permitted to be aggregated includes any debt-financed income that arises in connection with the qualifying partnership interest

Income from investment partnerships (continued)

Practical considerations:

- De minimis test – should organizations send a list of all partnership interests held to disqualified persons?
- De minimis test – timing of receipt of K-1's versus distribution of conflict-of-interest questionnaires.
- Control test – review every limited partnership agreement?
- Control test – specified language in limited partnership agreements going forward?
- Consider reviewing/revising the institution's investment policy.

Polling Question #3

Have you begun to work through the de minimis test and the control test for aggregation of investment partnerships? (Select all that apply)

- A. Yes—we are updating our conflict-of-interest questionnaires accordingly.
- B. Yes—we are reviewing limited partnership agreements.
- C. Yes—we are reviewing our investment policy.
- D. No—we have not yet taken action.
- E. We do not have investment partnerships.



Net operating losses

Net operating losses

- Net operating loss (NOL) deductions are allowed only with respect to the trade or business from which the loss arose
 - The change does not apply to NOLs arising in a tax year beginning before 1/1/18; such NOLs may be applied to reduce aggregate UBTI from all unrelated businesses
 - The Tax Cuts and Jobs Act limits NOLs carried forward to a tax year to 80% of the taxable income for the year for losses incurred in years beginning after 12/31/2017
- Fiscal year taxpayers – for fiscal year the year that includes December 31, 2017:
 - NOLs can offset 100% of future income (tax year begins before December 31, 2017)
 - No carryback and NOL carries forward indefinitely (tax year ends after December 31, 2017)

Net operating losses (continued)

Example – 80% NOL deduction limitation

UBTI (Form 990-T, Line 34)		\$500,000				
NOL Carryforward available		\$500,000				
	Taxable UBI	NOL Offset	Total Taxable UBI	Tax Rate	Tax	NOL CF
Pre Tax-Reform	500,000	(500,000)	None	34%	None	\$0
After Tax Reform – 2017 or prior loss CF	500,000	(500,000)	None	21%	None	\$0
After Tax Reform – 2018 loss CF	500,000	(400,000)	100,000	21%	21,000	\$100,000

Net operating losses (continued)

First tax year beginning after 12/31/2017 –

- No exempt organization with more than one unrelated trade or business will have an NOL deduction to take against the UBTI of a particular trade or business
- If the organization has pre-2018 NOLs, it may be able to take an NOL deduction against total UBTI

Second tax year beginning after 12/31/2017 –

- Organization may have both pre-2018 NOLs and post-2017 NOLs
- Section 512(a)(6) **may have** changed the order in which an organization would ordinarily take losses (in other words, post-2017 NOLs will be calculated and taken before pre-2018 NOLs)

Net operating losses (continued)

- Section 172 – **Net operating loss deduction**
 - 172(a) – NOL deduction allowed equal to the lesser of (1) the aggregate of the NOL carryovers plus carrybacks to the tax year, or (2) 80% of taxable income computed without regard to the deduction allowable under this section
 - 172(e) – In determining the amount of any NOL carryback or carryover to any tax year, the necessary computations involving any other tax year shall be made under the law applicable to such other tax year
- Section 512(a)(6) – **Special rule for organizations with more than 1 unrelated trade or business** –
 - UBTI, including for purposes of determining any NOL deduction, is computed separately with respect to each trade or business, then
 - UBTI is the sum of the UBTI so computed with respect to each trade or business

Net operating losses (continued)

- Open questions:
 - How should exempt organizations with more than one unrelated trade or business apply the 80% income limitation under section 172, particularly when the organization has both pre-2018 and post-2017 NOLs?
 - What is the ordering rule for pre-2018 and post-2017 NOLs?

Net operating losses (continued)

Practical considerations:

- Lost value on NOLs.
- Expiration of pre-2018 NOLs.
- Consider the integrity of current NOLs (IRS audit risk).
- Consider impact of new siloing rules on ASC 740 income tax accounting.

Polling Question #4

Have you thought about the implications of the Tax Cuts and Jobs Act on financial statement reporting of deferred tax assets, etc.?

- A. We plan on including a provisional amount in the financial statements.
- B. We do not yet plan on including a provisional amount in the financial statements.
- C. We have not yet considered the implications.



Fringe benefits

Fringe benefits

- Inclusion of certain employee fringe benefits (including qualified transportation fringes) in UBTI
- UBTI is increased by any amount:
 - For which a deduction is not allowable by reason of section 274, and
 - Which is paid or incurred by the organization for:
 - Any qualified transportation fringe (i.e. metro passes, bus fees, qualified parking, etc.) – section 132(f)
 - Any parking facility used in connection with qualified parking – 132(f)(5)(C), or
 - *On-premises athletic facility – 132(j)(4)(B)***
- Applies to amounts paid or incurred after 12/31/2017

*** Due to drafting errors, there are certain athletic facilities to which this provision would not apply.*

Fringe benefits (continued)

- Fringe benefits includible as UBTI are not subject to 512(a)(6)
- It appears as though:
 - If an organization has only one unrelated trade or business, a loss from that activity may offset amounts includable as UBTI under section 512(a)(7)
 - If an organization has more than one unrelated trade or business, which causes section 512(a)(6) to apply, it is unclear whether or how section 512(a)(7) income may be offset by any unrelated trade or business loss

Fringe benefits (continued)

Practical considerations:

- Gathering an inventory of available parking and transportation options.
- Identifying expense “paid or incurred.”
- Not subject to “siloining” provision, but can this increase in UBTI be offset by any losses?

Other

Other

- GILTI – IRS will view GILTI as similar to Subpart F, generally excluded from UBTI
- Social clubs, VEBAs, and supplemental unemployment compensation benefit trusts – special rules may apply

Questions

Questions





Thank You

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