

IRS Publishes Final Regulations Regarding UBTI “Silos”

January 14, 2021

As described in our previous [blog post](#), Code § 512(a)(6), which was enacted in 2017 as part of the Tax Cuts and Jobs Act (the “Act”), provides that, in the case of an organization with more than one unrelated trade or business, unrelated business taxable income (“UBTI”) shall be computed separately with respect to each such trade or business. Internal Revenue Code (“Code”) § 513(a) defines “unrelated trade or business” to mean any trade or business the conduct of which is not substantially related (aside from the need for income) to the exercise or performance by an exempt organization of its charitable, educational, or other purpose constituting the basis for its exemption. Unless a specific exception applies, gross income of an exempt organization derived from an unrelated trade or business that is regularly carried on by the organization (minus certain deductions that are directly connected with the carrying on of such trade or business) is taxable as UBTI.

Prior to the Act, an exempt organization’s income from unrelated businesses was calculated in the aggregate, enabling an organization to offset gains from one unrelated trade or business with losses from another. The Act eliminated this means for reducing the net taxable income from unrelated business ventures, but it did not provide guidance as to what constitutes a “separate” business for purposes of new § 512(a)(6). In August 2018, the Internal Revenue Service (“IRS”) issued [Notice 2018-67](#) (the “Notice”) setting forth interim guidance for determining what constitutes a separate unrelated trade or business for purposes of calculating UBTI. [Proposed regulations](#) were issued on April 24, 2020 (the “Proposed Regulations”) and, on December 2, 2020, the U.S. Treasury Regulations were amended to add [final regulations](#) under Code § 512(a)(6) (the “Final Regulations”).

The Final Regulations provide guidance regarding how an exempt organization determines if it has more than one unrelated trade or business and, if so, how the organization calculates UBTI under § 512(a)(6). According to the Final Regulations, an exempt organization must first determine whether it carries on unrelated trade or business activity that generates UBTI. If it so determines, the organization must then identify each of its separate unrelated trades or businesses using the first two digits of the North American Industry Classification System Code (“NAICS 2-digit Code”) that most accurately describes the unrelated trade or business. This identification is based on more specific NAICS codes such as the NAICS 6-digit code level (which identifies more than 1000 trades or businesses) and the descriptions in the current [NAICS manual](#), which describe trades or businesses using more than 2 digits. The businesses described in the more specific code levels are consolidated under twenty broad categories identified by the NAICS 2-digit Codes. Many trades or businesses that might otherwise be considered separate trades or businesses are aggregated under an NAICS 2-digit Code and may therefore be treated as one trade or business for purposes of § 512(a)(6).

The Final Regulations provide additional, detailed guidance regarding the computation of UBTI, including the following:

- **Aggregation under a single NAICS 2-digit Code:** An exempt organization may report each NAICS 2-digit Code only once, meaning an organization may aggregate trade or business activities that may occur in different geographic locations. However, if trade or business activities would be best described by two different NAICS 2-digit Codes, the activities must be treated as separate unrelated trades or businesses.
- **Deductions:** Code § 512(a)(1) provides that UBTI is the equal to gross unrelated business income minus certain deductions that are directly connected with the carrying on of such trade or business. The Final Regulations provide that an exempt organization with more than one trade or business must allocate such deductions between the separate unrelated trades or businesses using the “reasonable basis” standard. Under

this standard, the portion of any item allocated to an unrelated trade or business activity must be proximately and primarily related to that business activity. Expenses, depreciation and similar item attributable solely to the conduct of an unrelated trade or business are proximately and primarily related to that trade or business and qualify to reduce income from such trade or business to the extent such items meet certain requirements under the Code.

- **Net Operating Losses:** Code §§ 172(a) and 512(b)(6) allow a deduction for net operating losses (“NOLs”), defined as the excess of allowable deductions over gross income. For tax years beginning after December 31, 2017, UBTI must be computed separately with respect to each trade or business for purposes of determining any NOL deduction. Losses incurred from an unrelated business activity may be carried over to future taxable years without limitation, but carryovers may be used to offset income only with respect to the trade or business from which the loss arose. Under the Final Regulations, NOLs for taxable years beginning on or before December 31, 2017 may be used to offset an organization’s total UBTI, but only in a manner that allows for maximum utilization of NOLs for taxable years beginning on or after January 1, 2018.

- **Change of NAICS Classification:** An exempt organization that wishes to change the NAICS 2-digit identification of a separate unrelated trade or business must report the change in the taxable year of the change and provide (a) the NAICS 2-digit Code identification of the unrelated trade or business in the previous taxable year, (b) the NAICS 2-digit Code identification of the unrelated trade or business in the current taxable year, and (c) the reason for the change. Notably, the Notice provided that, for tax years preceding publication of the Final Regulations, an organization could rely on a reasonable, good-faith interpretation using the NAICS 6-digit codes to identify separate trades or businesses. The transition from NAICS 6-digit codes to NAICS 2-digit Codes could result in the combination of NOLs if an exempt organization has trade or business activities that would be separate unrelated trades or businesses if identified using NAICS 6-digit codes but would be one unrelated trade or business if identified using NAICS 2-digit Codes. To address this issue, the Final Regulations permit an exempt organization to amend a Form 990-T Exempt Organization Business Income Tax Return filed prior December 2, 2020 to report separate unrelated trades or businesses using NAICS 2-digit Codes.

- **Investment Activities “Silo”:** The Final Regulations continue to treat an exempt organization’s investment activities that are subject to unrelated business income tax as a separate unrelated trade or business for purposes of § 512(a)(6). For most exempt organizations, the exclusive list of investment activities that may be treated as a single, separate unrelated trade or business for purposes of § 512(a)(6) is as follows: (a) qualifying partnership interests (“QPI”); (b) qualifying S corporation interests; and (c) debt-financed properties. Note that an interest in a partnership is a QPI only if it meets the requirements of both (i) the de minimis test (i.e., the exempt organization holds, directly or indirectly, no more than 2 percent of the profits interest and no more than 2 percent of the capital interest in the partnership during the exempt organization’s taxable year with which or in which the partnership’s taxable year ends), and (ii) the participation test (i.e., the exempt organization directly holds no more than 20 percent of the capital interest, and does not “significantly participate” in the partnership).

- **Specified Payments from a Controlled Entity:** The Final Regulations provide that “specified payments” (defined as any interest, annuity, royalty, or rent) made to an exempt organization from an entity controlled by such exempt organization will be treated as gross income from a separate unrelated trade or business for purposes of § 512(a)(6). If a controlling organization receives specified payments from two different controlled entities, the regulations treat the payments from each controlled entity as income from separate unrelated trades or businesses.

- **Charitable Contribution Deduction:** Code § 512(b)(10) permits an exempt organization to take a charitable contribution deduction (limited to 10 percent of UBTI). The Final Regulations clarify that the charitable contribution deduction of an exempt organization with more than one unrelated trade or business is taken against the organization’s total UBTI.

- **Public Support Test:** There are generally two public support tests for public charities: (a) the Code § 509(a)(1) test, which requires that an organization receive at least one-third of its support from contributions from the general public (or meet the 10 percent facts and circumstances test), and (b) the 509(a)(2) test, which requires that an organization receive more than one-third of its support from contributions from the

general public and/or from gross receipts from activities related to its tax-exempt purposes, and no more than one-third of its support from gross investment income and UBTI. The Proposed Regulations noted that § 512(a)(6) could inadvertently impact calculation of public support because of the inability of an exempt organization with more than one unrelated trade or business to use losses from one unrelated trade or business to offset gains from another unrelated trade or business. The Final Regulations address this issue by permitting an exempt organization with more than one unrelated trade or business to determine public support using either its UBTI calculated under § 512(a)(6) or using its total, aggregate UBTI.

Additional guidance under the Final Regulations includes special rules regarding calculation of UBTI as related to controlled foreign corporations, social clubs, Voluntary Employees Beneficiary Associations, Supplemental Unemployment Benefits Trusts, individual retirement accounts, subpart F income and global intangible low-taxed income. The Final Regulations are applicable to taxable years beginning on or after December 2, 2020. For taxable years beginning on or after January 1, 2018 and before December 2, 2020, an exempt organization may choose to apply the Final Regulations or to rely on a reasonable, good-faith interpretation of § 512(a)(6), which includes the methods of aggregating or identifying separate trades or businesses provided in the Notice or the Proposed Regulations.

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related professionals

Pamela A. Mann / Partner

D 212-238-8758

mann@clm.com

Jeremy S. Steckel / Partner

D 212-238-8786

steckel@clm.com