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Initial impressions of proposed regulations on separately computed UBTI

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Today, the U.S. Treasury Department and IRS published **proposed regulations (REG-106864-18)** [PDF 395 KB] that provide guidance on section 512(a)(6), which was added to the Code by the 2017 tax law (Pub. L. No. 115-97) that is often referred to as the "Tax Cuts and Jobs Act." Section 512(a)(6) requires tax-exempt organizations with more than one unrelated trade or business to calculate unrelated business taxable income (UBTI) separately with respect to each trade or business.

The proposed regulations generally follow the approach taken in prior guidance on section 512(a)(6) provided in Notice 2018-67, although they make a number of modifications in response to comments from tax-exempt organizations on the Notice. The proposed regulations would generally treat much investment activity as a single trade or business and would classify most other unrelated business activities by using only the first two digits of the North American Industry Classification System (NAICS) code that most accurately describes the trade or business, rather than the more detailed six-digit NAICS codes proposed in Notice 2018-67.

The proposed regulations provide that in interpreting and applying section 512(a)(6), organizations may rely either on the proposed regulations, in their entirety, on Notice 2018-67, or on a reasonable, good faith interpretation of sections 511 to 514 only until the beginning of the first tax year after final regulations are issued. This suggests that organizations may be expected to implement the final regulations beginning the first tax year after they are published—which for calendar year taxpayers could be as early as January 1, 2021, if Treasury meets its stated goal of finalizing these regulations before the end of the year. However, if requested, Treasury could in final regulations extend this reliance on the proposed regulations, Notice 2018-67, and other reasonable, good faith interpretations of the statute, to provide organizations with a reasonable period (e.g., one year) to transition to the final regulations.

Comments regarding the proposed regulations and requests for a public hearing must be submitted by June 23, 2020.

Investment activities

The proposed regulations provide that tax-exempt organizations may treat certain investment activities collectively as a single unrelated trade or business. In particular, for most organizations,[1] all income, deductible expenses, and losses derived from the following investments could be aggregated in computing UBTI from those investments:

- Qualifying partnership interests (QPIs);
- Qualifying S corporation interests; and
- Debt-financed property or properties (within the meaning of section 514).

As in Notice 2018-67, QPIs are generally defined as partnership interests that meet one of two tests:

- **A de minimis test**, which the exempt organization satisfies if it holds directly no more than 2% of the profits interest and no more than 2% of the capital interest of the partnership; or

- **A control test**, which the exempt organization satisfies if it directly holds no more than 20% of the capital interest and does not control the partnership, taking into account all facts and circumstances.

[1] The rules in the proposed regulations for social clubs described in section 501(c)(7), voluntary employees' beneficiary associations described in section 501(c)(9), and supplemental unemployment benefits trusts described in section 501(c)(17), all of which are subject to the special UBIT rules of section 512(a)(3), are somewhat different and not summarized in this *TaxNewsFlash*.

However, in response to comments on Notice 2018-67, several modifications were made to the control test. Notably, while the control test in Notice 2018-67 looked to whether the exempt organization had "control or influence" over the partnership the proposed regulations revised the control test to remove the reference to "influence." In addition, the proposed regulations clarify that an organization would have control over a partnership if the organization "by itself" (as opposed to with other partners) may require the partnership to perform or not perform any act that significantly affects the operations of the partnership or may appoint or remove a "majority" (as opposed to any) of the partnership's directors (or any of the partnership's officers or employees). The proposed regulations, like Notice 2018-67, also indicate that control would exist if any of the exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time.

In addition, in response to comments on Notice 2018-67, the interests of disqualified persons do not need to be taken into account under the proposed regulations in applying the percentage thresholds of the de minimis and control tests. Rather, only the interests of supporting organizations and controlled entities must be combined with those of the organization itself and, further, only need to be combined in the case of the control test, not the de minimis test.

Finally, the proposed regulations provide a "look-through" rule that allows aggregation of some investments in "fund of funds" partnerships. Under the look-through rule, if an organization directly holds more than 20% of the capital interest of, but does not control, a partnership, then any lower-tier partnership (held indirectly through the directly-held partnership interest) could be a QPI if the indirectly-held partnership interest meets the requirements of the de minimis test.

The proposed regulations temporarily maintain the "transition rule" that was provided in Notice 2018-67, under which a partnership interest acquired prior to August 21, 2018, may be treated as comprising a single trade or business for purposes of section 512(a)(6). The proposed regulations helpfully clarify that a partnership interest acquired prior to August 21, 2018, will continue to meet the requirement of this transition rule even if the organization's percentage interest in such partnership subsequently changes. However, under the proposed regulations, an organization's ability to rely on the transition rule ends at the beginning of the first tax year after final regulations under section 512(a)(6) are issued.

Similar to the Notice, the proposed regulations allow exempt organizations to rely upon the Schedule K-1 provided by a partnership for purposes of the de minimis and the control test in certain circumstances. Once an organization designates a partnership interest as a QPI, it cannot subsequently identify trades or businesses of the partnership using the NAICS codes, unless and until the partnership does not qualify as a QPI, in which case, the organization would be required to identify the partnership's trades or businesses using NAICS codes.

A qualified S corporation interest would be an S corporation interest that meets either the de minimis or control test for QPIs (looking to ownership of stock rather than profits interest).

Other business activities

Under the proposed regulations, most other business activities would be classified pursuant to 2-digit NAICS codes, as opposed to the more specific 6-digit NAICS codes proposed in Notice 2018-67, which were widely criticized by commenters. (**NAICS codes** [PDF 7.3 MB] identify trades or businesses in 20 economic sectors.) However, the following activities would automatically be treated as separate trades or businesses under the proposed regulations:

- **Specified payments from controlled entities.** All "specified payments" (that is, interest, rents, royalties, and annuity payments described in section 512(b)(13)(C)) received by a controlling tax-exempt organization from an entity that it controls (within the meaning of section 512(b)(13)(D)) would be treated as gross income from a separate unrelated trade or business. If a controlling organization receives specified payments from two different controlled entities, the payments from each controlled entity would be treated as a separate unrelated trade or business.

- **Certain amounts derived from controlled foreign corporations (CFCs).** All amounts included in UBTI under section 512(b)(17) would be treated as income derived from a separate unrelated trade or business.

- **S corporation interests.** Any S corporation interest, other than a qualified S corporation interest, would be treated as an interest in a separate unrelated trade or business.

Once an exempt organization identifies a two-digit NAICS code for the trade or business, it would not be able to change it unless the NAICS code originally identified was erroneous.

Net operating losses (NOLs)

Under section 512(a)(6), NOLs arising in a tax year beginning before January 1, 2018 ("pre-2018 NOLs") may be taken against aggregate UBTI, while NOLs arising in a tax year beginning after December 31, 2017 ("post-2017 NOLs") may only be taken against UBTI from the trade or business from which the post-2017 NOL arose. The proposed regulations provide that an exempt organization with both pre-2018 NOLs and post-2017 NOLs would have to deduct its pre-2018 NOLs from its aggregate UBTI before deducting any post-2017 NOLs from the UBTI of the separate trade or business that gave rise to the NOL. The proposed regulations further indicate that pre-2018 NOLs would have to be taken against aggregate UBTI in the manner that results in maximum utilization of the pre-2018 NOLs in a tax year.

Charitable contributions

Section 512(b)(10) permits tax-exempt corporations to take charitable contribution deductions under section 170 up to 10% of the UBTI, while section 512(b)(11) limits the deduction of tax-exempt trusts to the percentage limitations applied to individuals under section 170(b)(1)(A) and (B) determined with reference to UBTI. The proposed regulations provide that in applying these percentage limitations, exempt organizations would use aggregate UBTI computed pursuant to section 512(a)(6).

Allocation of expenses

The preamble to the proposed regulations state that rules regarding the methods of allocating expenses, depreciation, and similar items between unrelated business activities and exempt activities or between separate unrelated business activities will be issued in separate proposed regulations. However, these proposed regulations provide that using one method—the "unadjusted gross-to-gross method"—is not reasonable. An "unadjusted gross-to-gross method" is a revenue-based method that does not account for differences in the prices charged for an activity.

Public support tests

The proposed regulations would revise the "public support tests" that section 501(c)(3) organizations use to qualify as public charities (as opposed to private foundations) by permitting an organization to aggregate net income and net losses from all of its unrelated business activities for purposes of determining whether the organization is publicly supported.

Subpart F and global intangible low-taxed income

As in Notice 2018-67, the proposed regulations clarify that inclusions of subpart F income under section 951(a)(1)(A) and global intangible low-taxed income (GILTI) under section 951A(a) are treated in the same manner as dividends for purposes of section 512(b)(1).

Contact us

For more information, contact a tax professional with KPMG's Washington National Tax practice:

Ruth Madrigal
T: +1 (202) 533-3800
E: ruthmadrigal@kpmg.com

Ossie Borosh
T: +1 (202) 533-5648
E: oborosh@kpmg.com

Preston Quesenberry
T: +1 (202) 533-3985
E: pquesenberry@kpmg.com

www.kpmg.com

kpmg.com/socialmedia