UBIT Changes for Benefit Plan Investors and the 2018 Tax Year Filing Season

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May 15, the due date for a calendar year tax-exempt organization's Form 990-T return, is fast approaching. Plans with "unrelated business income tax" ("UBIT") arising from investments may be grappling with how to handle calculating and reporting UBIT, in light of changes wrought by the 2017 Tax Cut and Jobs Act (the "Tax Act"). IRS Notice 2018-67 (the "Notice"), issued last August, provided interim guidance on changes to UBIT under the Tax Act, but many plan investors have lingering questions about their approach to reporting UBIT – especially since IRS will not issue additional guidance prior to this year's return due date. In the enclosed Benefits Brief, we summarize the Tax Act's changes with respect to UBIT, the guidance provided by the Notice, and potential options for plan investors as they prepare to file their Forms 990-T.

Background

Under the UBIT rules, a tax-qualified retirement plan (including a pension plan, an IRA, or a VEBA) may have UBIT merely by investing in a limited partnership that borrows to make one or more investments. Under Code section 514, ownership of such "debt-financed property" generally causes a proportionate share of the income from that investment to be subject to UBIT. A longstanding (though complex) provision exempts most debt-financed real estate investments from UBIT for pension plans (though this does not apply to VEBAs). IRC § 514(c)(9). Plans have often used foreign "blocker" corporations to shelter other income from UBIT, although the costs and benefits of that approach need to be examined on a case-by-case basis. And even if no debt is used, if a limited partnership invests in an active trade or business (e.g., directly operates a hotel or participates in an operating company), the plan investor's income will be subject to UBIT on a "look-through" basis. IRC § 512(c).

The calculation of UBIT allows an investor to claim its share of associated expenses against the income – and to net most gains and losses – just like any taxpayer. IRC § 512(a)(1). In the case of a trust, the

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net income is subject to the individual tax rates – as high as 37% in 2018 – and reported on IRS Form 990-T. IRC § 511(b). State taxes and filings also may apply.

What the Recent Tax Act Changed

Effective for tax years beginning after December 31, 2017, benefit plans with two or more unrelated trades or businesses will no longer be able to "net" the income and losses of the businesses in the aggregate when determining UBIT. Instead, the UBIT for the tax year is based on the sum of unrelated business income ("UBI") (but not less than $0) for each trade or business. IRC § 512(a)(6). The Tax Act also limits the application of the carryover of net operating losses for tax years beginning after December 31, 2017 to the UBI of the same trade or business in future years. However, net operating losses from tax years beginning prior to 2018 can still be applied to any trade or business to reduce the amount of UBI subject to UBIT.

Key Aspects of the Notice for Benefit Plan Investors

A key area of uncertainty in this area is whether each investment held by a plan would be viewed as a separate "trade or business," or alternatively, whether a plan can consider all investments of the same "type" (e.g., all real estate investments or all private equity funds) as a single trade or business. The Notice provides a variety of rules that plans may apply to simplify the impact of this change.

A. **Reasonable, Good Faith Interpretations –** The Notice states that exempt organizations "may rely on a reasonable good faith interpretation" of the UBIT rules, considering all the facts and circumstances, when determining whether the organization has more than one trade or business under the new rules. This principle recognizes that the concept of a "separate trade or business" is not defined and may even vary under different Code sections. The Notice also provides a safe harbor under which a six-digit code described in section 3.03 of the North American Industry Classification System ("NAICS") may be considered a "trade or business" separate from an activity in another six-digit code. The Notice suggests that this use of the NAICS codes may be adopted as a permanent rule.

B. **Relief for Investment Activities –** Several provisions in the Notice should reduce situations where a benefit plan investor has UBI, such as the look-through rule for partnerships in which a tax-exempt organization invests (IRC §§ 512(c), 513(a)). In light of the complexity of partnership structures, such as private equity "fund of funds," Treasury and IRS intend to propose rules that allow certain investments to be treated as a single trade or business, provided that "the exempt organization does not significantly participate" in any partnership trade or business. Importantly, on an interim basis, the Notice provides a "de minimis" test, a "control" test, and a grandfather rule for determining which partnership interests or holdings may be aggregated in calculating UBI. We briefly describe these rules below.

   - ***"De Minimis" Rule*** – Under this rule, an organization may aggregate its UBI from a single partnership owning multiple trades or businesses, or from "qualifying partnership interests" in the aggregate, if the organization directly holds no more than two percent of

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the profits interest and no more than two percent of the capital interest in those partnerships. The Schedule K-1 (which each partnership investor is required to receive) may be relied on in applying the two percent threshold with certain calculation rules described in the Notice, including aggregating the interests of a disqualified person or controlled entity.

- ***"Control" Test*** – Under the "control" test, if the organization directly holds no more than 20 percent of the capital interest in a partnership (again based on the K-1), and does not have "control or influence" over partnership activities based on the facts and circumstances, it may aggregate its UBI from a single partnership owning multiple trades or businesses or combine the results of such a holding with its other "qualifying partnership interests" in applying the new rules (i.e., it need not make a separate calculation of UBI with respect to each partnership interest). The Notice states that "all facts and circumstances are relevant for determining whether an exempt organization has control or influence over a partnership" and that "control or influence" includes the power of an exempt organization to require a partnership to perform, or refrain from performing, "any act that significantly affects the operations of the partnership." This leaves some important questions unanswered, such as whether a plan investor's participation in a partnership's limited partner advisory committee constitutes a position of "control or influence."
- ***Grandfather Rule*** – Finally, recognizing that it may be difficult to make the above de minimis and "control" determinations, the Notice generally allows each existing partnership interest as of August 21, 2018 to be treated as a single trade or business – even where the partnership indirectly holds multiple lower-tier partnerships (e.g., a "fund of funds" investment arrangement). The Notice makes it clear that these special aggregation rules apply to unrelated debt-financed income (Code sec. 514) as well as to the income from the partnership investment.

Comments in Response to the Notice

Treasury and IRS requested and received numerous comments in response to the Notice from and on behalf of tax-exempt organizations. While the comments were supportive of many parts of the Notice, many commenters raised serious concerns about administering the interim rules. In addition –

- Some commenters suggested alternative treatments of income generated from investments in a partnership, including narrowing the definition of "control" for purposes of the "control test" (e.g., setting the threshold at 50% (not 20%)). The use of a "limited liability test" also was advocated in the comments.
- Some commenters suggested investment partnerships should be treated as one trade or business, or, alternatively, that a "trade or business" should not include investment activities.
- Some commenters did not embrace the six-digit NAICS code safe harbor. For example, one commenter noted that NAICS codes do not reliably identify separate trades or businesses and

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that using NAICS codes at the two-digit level would be more administrable than using six-digit codes.

- Some commenters requested that rules for benefits plans differ from rules for other tax-exempt organizations. For example, one commenter suggested that pension funds and health and welfare funds be able to rely on their respective six-digit NAICS codes for purposes of complying with the new UBIT rules (i.e., a pension or welfare fund simply would be considered a single trade or business).

Changes in Form 990-T

Consistent with the Tax Act changes, the IRS has revised the Form 990-T to require filers with more than one unrelated trade or business to complete portions of the form for one trade or business and attach a separate Schedule M for each additional trade or business. The instructions list a selection of codes from the NAICS and suggest filers select the most specific six-digit code available that describes the activity producing the income being reported. The instructions also note that most codes describe more than one type of activity and that filers should avoid using codes that describe the organization rather than the income-producing activity.

Options Available to Tax-Exempt Organizations

Unfortunately, the IRS will not be issuing further guidance on this topic before the general 2018 tax-exempt filing deadline for calendar-year organizations (May 15, unless an extension is requested). The next phase of IRS guidance will likely be proposed regulations, which must go through a lengthy clearance process at Treasury and the IRS, including coordination with Office of Management and Budget staff.

Until regulations are issued, tax-exempt organizations affected by these UBIT changes should work with the guidance in the Notice, and with their professional tax advisers, in preparing their Forms 990-T. Possible approaches could include, for instance:

- Relying on the six-digit NAICS code safe harbors.
- If the six-digit NAICS code safe harbor is not considered viable for a particular organization or investment, relying on a "reasonable good faith interpretation" within the meaning of the Notice.
- Reviewing partnership structures and, if appropriate and applicable, applying the de minimis rule, the "control" test, or the grandfather rule.
- Completing the revised Form 990-T under a "reasonable and good faith" approach – e.g., using the NAICS code for the applicable benefits fund to report trust investments.

Groom attorneys are closely following these developments and are well-positioned to help clients achieve practical solutions.

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