XIII. Unrelated Business Income Tax: Key Changes

A. Introduction

Since President Trump signed the Tax Cuts and Jobs Act (TCJA) into law on December 22, 2017,[1] the TCJA has impacted individuals, businesses, and tax-exempt organizations.[2] While the TCJA benefits individuals and for-profit businesses—primarily through lower individual and corporate tax rates—the bill has generally been stricter towards tax-exempt entities.[3] One significant change to the treatment of tax-exempt entities has been the TCJA's impact on the unrelated business income tax (UBIT).[4] Tax-exempt organizations derive unrelated business income from activities that are not substantially related to the performance of their tax-exempt purposes.[5] According to the Internal Revenue Service (IRS) Statistics of Income Division, over 43,000 tax-exempt organizations filed forms reporting gross unrelated business income of $11 billion in 2010.[6] Of these tax-exempt organizations, over half did not sustain any UBIT

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[1] *Effects of the Tax Cuts and Jobs Act: A Preliminary* Analysis, BROOKINGS INSTITUTION (June 14, 2018), https://www.brookings.edu/research/effects-of-the-tax-cuts-and-jobs-act-a-preliminary-analysis/ [https://perma.cc/UH8H-PTZ3] (announcing the enactment of the TCJA).

[2] Jessica Keefe & Ryan McDonell, *Tax Reform Impact on Exempt Organizations and UBTI*, O'CONNOR & DREW P.C. (Sept. 26, 2018), https://www.ocd.com/tax-reform-impact-on-exempt-organizations-and-ubti/ [https://perma.cc/S7KK-VMUB] (introducing the wide-ranging effects of the TCJA on different entities).

[3] Huaqun Li & Kyle Pomerleau, *The Distributional Impact of the Tax Cuts and Jobs Act Over the Next Decade*, TAX FOUND. (June 28, 2018), https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/ [https://perma.cc/8HQJ-RNHA] ("The TCJA made changes to both the individual income and corporate income tax, while scaling back the estate and gift tax. Over the next decade, we estimate that the TCJA will reduce federal revenues by about $1.8 trillion on a conventional basis.").

[4] *See, e.g.*, *Tax-Exempt Organizations: IRS Provides Guidance on New UBTI Rule*, ABAMS LITTLE-GILL LOBERFELD PC: ALL CPAS (Sept. 19, 2018), https://all-cpas.com/tax-exempt-organizations-irs-provides-guidance-on-new-ubti-rule [https://perma.cc/46CK-HMLD].

[5] 26 U.S.C. § 513(a) (2012) (defining "unrelated trade or business").

[6] *See generally* JAEL JACKSON, INTERNAL REVENUE SERV., STATISTICS OF INCOME BULLETIN: UNRELATED BUSINESS INCOME TAX RETURNS, 2010 (2014), https://www.irs.gov/pub/irs-soi/soi-a-eoub-id1403.pdf [https://perma.cc/CLL9-HERW] (reporting the filing statistics of tax-exempt organization).

liability after subtracting deductions, and those that did had offsetting deductions in the amount of $10.8 billion—leaving a taxable fraction of 1.8%.[7]

The UBIT first received legislative treatment in the Revenue Act of 1950 when Congress responded to New York University School of Law extending its tax-exempt status to income received from the Mueller Macaroni Company.[8] In the Senate Finance Committee Report, the legislature characterized the problem as creating "unfair competition" between tax-exempt organizations expanding with tax-free profits and non-exempt entities relying on post-tax profits to fuel their expansions.[9] Since its first attempt to address unfair competition, the legislature has struggled to reign in this activity.[10] As Susan Rose-Ackerman noted:

> The unresolved issue of the law's coverage will be of growing concern to nonprofits since current cuts in marginal tax rates and in government subsidies will undoubtedly induce many nonprofit firms to consider profitmaking activities as a way to raise funds. As nonprofits try to enter new fields, such as genetic engineering and cooperative research relationships with private firms, Congress and the IRS will have to decide whether to facilitate or impede these activities.[11]

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[7] *Id.* (reporting the taxable income left after UBIT deductions taken by tax-exempt organizations as being a small fraction of the gross amount).

[8] In 1947, a wealthy alumni couple donated the Mueller Macaroni Company to New York University (NYU) to help fund its expansion. *See* Stephen T. Black, *Do You Want Innovation and Jobs? Repeal § 511*, 57 WASHBURN L.J. 431, 434 (2018). After the IRS determined a deficiency on NYU's reported taxes, the Third Circuit applied the "destination of income" test to reverse the agency's decision. *Id.* at 433 (citing C.F. Mueller Co. v. Comm'r, 14 T.C. 922 (1950), *rev'd*, 190 F.2d 120 (3d Cir. 1951)).

[9] THOMAS B. RIPY ET AL. , CONG. RESEARCH SERV., 87-248A, HISTORY AND CONTINUING ISSUES ON UNRELATED TRADE OR BUSINESS INCOME TAX: SECTIONS 511-513 OF THE INTERNAL REVENUE CODE (1987) (citing the Senate Finance Committee Report in addressing the legislative history); S. REP. NO. 2375, at 27 (1950), 1950-2 C.B. 483, 504.

[10] Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1017–18 (1982).

[11] *Id.*

The first major wave of reforms came in the Tax Reform Act of 1969 when Congress broadened coverage of the existing law to include previously excluded tax-exempt entities.[12] The Tax Reform Act of 1969 extended coverage to "all tax-exempt organizations described in Internal Revenue Code sections 501(c) and 401(a) (except United States instrumentalities)."[13] Examples of such tax-exempt entities included churches, social clubs, and fraternities.[14] Next, the Tax Reform Act of 1976 established taxes on net investment income for tax-exempt organizations, and created carve-outs for "qualified entertainment activities" and "qualified trade show and convention activities."[15] In creating the carve-outs, the legislature rejected certain IRS Revenue Rulings, and cited the absence of a competitive threat with for-profit business and the customary or promotional nature of these events as justification.[16]

Most recently, Congress, through enacting the TCJA, has adopted key changes relating to the UBIT and other provisions to promote the original goal of encouraging competition by inhibiting tax-exempt organizations from competing with for-profit entities in similar trades and businesses.[17] In particular, the bill relies on the limitation on UBIT aggregation, changes to the designation process of unrelated trades or businesses, elimination of certain fringe benefits, reduction of the net operating loss (NOL) deduction, and limitations on the role of tax-exempt organizations in for-profit partnerships.[18]

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[12] RIPY ET AL., *supra* note 9 (reviewing the legislative history of the UBIT on tax-exempt organizations).

[13] PAUL ARNSBERGER ET AL., INTERNAL REVENUE SERV., STATISTICS OF INCOME BULLETIN: A HISTORY OF THE TAX-EXEMPT SECTOR: AN SOI PERSPECTIVE (2008), https://www.irs.gov/pub/irs-soi/tehistory.pdf [https://perma.cc/U2GN-92XV] (summarizing key developments in the legislative treatment of the tax-exempt sector).

[14] RIPY ET AL., *supra* note 9 (listing examples of tax-exempt entities brought into the purview of the 1969 Tax Reform Act).

[15] *Id.*; ARNSBERGER ET AL., *supra* note 13.

[16] S. REP. NO. 94-938, pt. 1, at 601–03 (1976) (responding to IRS rulings that taxed the organizers of a county fair on income from horse race betting and a tax-exempt business league generating income from renting display space at its convention show).

[17] *Tax-Exempt Organizations: IRS Provides Guidance on New UBTI Rule*, *supra* note 4 (referring to changes in UBIT treatment resulting from passage of the TCJA).

[18] *See generally* KPMG, TAX REFORM: ISSUES OR EXEMPT ORGANIZATIONS (PUB. L. 115-97) (2018), https://home.kpmg/content/dam/kpmg/

While eliminating these organizations' tax advantages in conducting unrelated activities might promote competition, the same policies may have the unintended consequence of reducing the ability of non-profit organizations to pursue their tax-exempt purposes.[19] In light of other changes in the tax code such as the higher standard deductions and an increased threshold for taxable estates and gifts, potential donors would receive less of a tax benefit from the charitable contributions compared to prior law.[20] Some commentators have further suggested that these changes may have harmful distributional consequences when coupled with the increased charitable contribution deduction limit of sixty percent for cash contributions.[21] They worry that the changes will shift the benefits of the tax expenditures to higher-income households.[22]

Part B discusses changes to the UBIT, including limitations on aggregation, designation of unrelated business or trade activity, and fringe benefits. Part C explores changes to the NOL deductions and their specific effects on tax-exempt organizations. Part D discusses the treatment of tax-exempt organizations in partnerships and funds in

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us/pdf/2018/02/tnf-exempt-org-mini-feb2-2018.pdf [https://perma.cc/CGP6-NVMJ] (highlighting major changes affecting tax-exempt organizations resulting from passage of the TCJA, including specific changes to UBIT, NOL deductions, partnerships, and excise tax).

[19] Catherine Petercsak & Kerri Bogda, *Post-TCJA Considerations for Exempt Organizations*, N.Y. ST. SOC'Y CERTIFIED PUB. ACCT. (July 1, 2018), https://www.nysscpa.org/news/publications/the-trusted-professional/article/post-tcja-considerations-for-exempt-organizations [https://perma.cc/7E26-R8TN] ("This new tax law significantly changes the taxation landscape for tax-exempt entities . . . . The new rules for individuals and corporations might leave many charitable organizations with reduced critical revenue from gifts or charitable donations in the coming years. Organizations that have not been subject to unrelated business income in the past might now have an unforeseen tax liability and might be required to make estimated payments now for 2018. Tax-exempt entities must proactively plan to address the impact of the new tax law on their business operations.").

[20] *Id.* (suggesting that the TCJA would have a deteriorative impact on donor tax exemptions).

[21] 26 U.S.C. § 170(b)(1)(G)(i) (2012); Howard Gleckman, *The TCJA Shifted the Benefits of Tax Expenditures to Higher-Income Households*, TAX POL'Y CTR. (Oct. 16, 2018), https://www.taxpolicycenter.org/taxvox/tcja-shifted-benefits-tax-expenditures-higher-income-households [https://perma.cc/WP83-WYJD].

[22] Gleckman, *supra* note 21 ("[T]he benefits of many itemized deductions have shifted from middle-income households to those with higher incomes.").

light of the limitations on aggregation. Part E concludes with a summary of the changes.

B. UBIT Changes

Section 501(a) generally exempts §§ 401(a) and 501(c) organizations from federal income taxation.[23] "Unrelated business taxable income" is defined in 26 U.S.C. § 512(a) and has three components.[24] It is defined as the gross income from all (i) unrelated, (ii) trade or businesses that are (iii) regularly carried on by the organization.[25] Before the changes to the tax code, tax-exempt entities were permitted to aggregate the gross incomes and deductions from all unrelated businesses, and pay taxes on the net amount.[26] This permitted exempt organizations, such as educational institutions, to offset positive incomes from trade or business activities with losses from activities that never generated profits, including fitness centers, recreation centers, advertising, and golf courses.[27] In its Colleges and Universities Compliance Project Report (Compliance Report), the IRS examined 34 out of the 400 randomly selected educational institutions that participated in the study, and disallowed over $170 million in losses and NOLs.[28] The primary reasons for increasing the UBIT on

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[23] 26 U.S.C. § 501(a) ("An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation.").

[24] 26 U.S.C. § 512(a)(1); Adam Bergman, *Beware Unintended Tax Consequences of Unrelated Business Income*, FORBES (July 15, 2015, 11:35 AM), https://www.forbes.com/sites/greatspeculations/2015/07/15/beware-unintended-tax-consequences-of-unrelated-business-income/#324c664526b7 [https://perma.cc/QU49-WE4F].

[25] *Id*.

[26] Megan E. Bell et al., Am. Bar Ass'n Sec. of Taxation, *Comments on Internal Revenue Code Section 512(a)(6) Special Rules for Organizations with More Than One Unrelated Trade or Business* 2 (2018), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/062118comments.pdf [https://perma.cc/PSA6-ZTAC] ("Prior to the enactment of section 512(a)(6), as part of Public Law 115-97 . . . exempt organizations were permitted to aggregate their losses and gains from all unrelated business taxable income . . . and then report and pay taxes on the net UBTI, if any.").

[27] *Id.* at 5 (describing certain college and university practices that allowed these tax-exempt organizations to avoid taxation on their unrelated business or trade incomes).

[28] INTERNAL REVENUE SERV., COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT FINAL REPORT 2 (2013), https://www.irs.gov/pub/irs-tege/CUCP_

the examinations in order of financial impact were: lack of profit motive, improper expense allocation, computational and substantiation errors, and reclassification of activities as unrelated.[29] Other than UBIT, the report addressed compliance issues related to executive compensation and wages, which will not be discussed in this article.[30] The following subsections will discuss the changes under the TCJA that address the concerns reflected in the IRS Colleges and Universities Compliance Project Report—specifically, aggregation, designation, and fringe benefits.

1. § 512(a)(6) Silo Rule

One of the major additions to the TCJA affecting tax-exempt organizations was Section 512(a)(6).[31] Section 512(a)(6) is colloquially referred to as the "silo" or "fragmentation" rule.[32] This provision requires exempt organizations with more than one unrelated trade or business to compute the UBIT separately for each trade or business.[33] An "unrelated trade or business" is defined in 26 U.S.C. § 513 as any trade or business conduct that is "not substantially related"[34] to the organization's tax-exempt purpose.[35]

FinalRpt_050213.pdf [https://perma.cc/B8LE-94GY] [hereinafter IRS COMPLIANCE REPORT].

[29] *Id.*

[30] *Id.*

[31] Pub. L. 115-97, 131 Stat. 2168 (2017).

[32] *See, e.g.*, Bell et al., *supra* note 26 ("[S]ection 512(a)(6) . . . has colloquially been referred to as the 'silo' rule . . . ."); *Taxation of Unrelated Business Income (UBIT)*, HURWIT & ASSOCIATES, https://www.hurwitassociates.com/taxation-of-unrelated-business-income/taxation-of-unrelated-business-income [https://perma.cc/Z26J-7G2M] (referring to the limitations on aggregation under § 512(a)(6) as the "fragmentation rule").

[33] 26 U.S.C. § 512(a)(6) (2012) (imposing new requirements for calculating income derived from separate unrelated trades or businesses).

[34] Michael McNee et al., *Has Unrelated Business Taxable Income Been Properly Captured?*, MORRIS & MCVEIGH LLP 30–31 (May–June 2016), http://www.morrisandmcveigh.com/Libraries/PDS_s/UBTI_article_2.sflb.ashx ("The third criterion in determining UBTI is whether the trade or business activity is substantially related to the organization's exempt purpose. A trade or business is treated as related to an organization's exempt purposes only if it has a causal relationship to the organization's ability to achieve those exempt purposes (other than by the production of income). In addition, the relationship must be substantial. Specifically, in order to be substantially related to the

This change addresses the concerns expressed by the IRS in its Compliance Report regarding the lack of profit motive and improper expense allocation.[36] Because the gross incomes and deductions of each trade or business must be treated separately[37] and the UBIT with respect to any trade or business may not be less than zero,[38] organizations have less incentive to pursue activities that do not generate recurring positive incomes.[39] The silo rule is one of the most significant changes resulting from the TCJA and it is worth emphasizing that unrelated business income must be computed with respect to *each* unrelated trade or business.[40] Prior to the passage of this provision, tax-exempt organizations could aggregate income from all unrelated activities and offset incomes from one trade or business with deductions from another.[41]

2. Designation

The IRS has noted that "[t]here is no general statutory or regulatory definition defining what constitutes a 'trade or business' for purposes of the Internal Revenue Code."[42] Before the adoption of the new legislation, qualification of an activity as a trade or business in the context of § 512(a)(6) had to meet the threshold question of whether the institution had an intention to profit from the activity.[43] Courts and

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purposes for which exemption is granted, the production or distribution of the goods or the performance of the services producing the income must contribute importantly to the accomplishment of the exempt purposes. Whether activities contribute importantly to an organization's exempt purposes depends on the facts and circumstances of each case.")

[35] The "not substantially related" language existed in the previous tax code, and we suspect will retain the same meaning developed in prior judicial and regulatory proceedings. *See id.* at 30–32.

[36] IRS COMPLIANCE REPORT, *supra* note 28.

[37] 26 U.S.C. § 512(a)(6)(A).

[38] 26 U.S.C. § 512(a)(6)(C) (disallowing, in effect, losses attributable to the generation of UBTI for an unrelated trade or business in that taxable year).

[39] IRS COMPLIANCE REPORT, *supra* note 28 (suggesting that entities will be dissuaded from pursuing certain business lines).

[40] 26 U.S.C. § 512(a)(6)(A).

[41] Christine L. Noller et al., *Impact of the Tax Cuts and Jobs Act of 2017 on Tax-Exempt Hospitals*, 30 HEALTH LAW. 20, 20 (2018).

[42] I.R.S. Notice 2018-67, 2018-36 I.R.B. 409.

[43] IRS COMPLIANCE REPORT, *supra* note 28 ("An activity qualifies as a trade or business if, among other things, the taxpayer engaged in the activity with

the IRS have relied on different analyses to determine whether an activity constituted a trade or business depending on which section of the code was involved.[44] Recently, the IRS has considered a "facts and circumstances" test and looked to other provisions of the code[45] to define a "trade or business," but decided that these methods would be ineffective and pose too great an administrative burden.[46] Instead, it is considering allowing use of the North American Industry Classification System (NAICS) to be a reasonable, good faith interpretation of the statute until issuance of the proposed regulations.[47]

The NAICS is a standard used by federal statistical agencies to collect, analyze, and publish data related to the U.S. business economy.[48] While having such a bright line rule may ease the administrative burden and allow consistent application of the law, it may also miss some of the nuance and create different kinds of unnecessary burdens.[49] As some have already pointed out, the NAICS is inclusive

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the intention of making a profit . . . . When income is attributable to an activity lacking a profit motive, a loss from the activity cannot be claimed.").

[44] *See generally*, Comm'r v. Groetzinger, 480 U.S. 23, 27 (1987) ("The difficulty has not been ameliorated by the persistent absence of an all-purpose definition, by statute or regulation, of the phrase 'trade or business' . . . o]f course, this very frequency well may be the explanation for legislative and administrative reluctance to take a position as to one use that might affect, with confusion, so many others.").

[45] Specifically, the IRS has looked at 26 U.S.C. §§ 132, 162, 183, 414, and 469 for guidance on defining a "trade or business." I.R.S. Notice 2018-67, 2018-36 I.R.B. 409.

[46] *Id.* (acknowledging the administrative burdens on both the filing tax-exempt entities and the IRS in enforcing §512(a)(6) under a facts and circumstances test, where a fact-intensive analysis would be required and may lead to inconsistencies across tax-exempt sectors due to differing approaches in budgeting and staffing).

[47] *Id.*

[48] EXEC. OFFICE OF THE PRESIDENT, OFFICE OF MGMT. & BUDGET, N. AM. INDUS. CLASSIFICATION SYS. (2017), https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf.

[49] Amy Lee Rosen, *Unrelated Business Tax Regs May Bring Nonprofits Headaches*, LAW360: TAX AUTHORITY (Aug. 22, 2018), https://www.law360.com/tax-authority/articles/1075822/print?section=tax-authority/federal. ("Recent guidance by the Internal Revenue Service fleshing out how nonprofits determine unrelated business taxable income could cause administrative burdens for the organizations because it would require them to track income and losses with an arcane coding system not designed for tax purposes.").

of some income sources, such as advertising income regardless of the source, but the coding system becomes troubling for other types of businesses, such as real estate.[50] Under the NAICS, rental income coming from a banquet hall differs from those coming from vacant lots and roofs rented out for cell towers.[51] Some worry that under this scheme, exempt entities would not be permitted to aggregate income generated from different activities, even if generated from the same asset—for instance, the same parcel of real property.[52] Other practitioners worry that this designation system may have a disproportionately adverse effect on smaller nonprofit organizations that will not be able to afford the additional UBIT expenses.[53] Note, however, that the NAICS is not preclusive of other "reasonable, good faith interpretation[s] of the law" in determining separate trades or businesses.[54]

3. § 512(a)(7) Fringe Benefits

Another provision specifically affecting tax-exempt organizations was the TCJA's addition of Section 512(a)(7).[55] Exempt entities must now include certain fringe benefits in the calculation of UBIT.[56] These benefits include qualified transportation fringes (QTFs), parking facilities connected with qualified parking, and on-site athletic facility fringe benefits as addressed in section 132(f) and (j).[57] Prior to the enactment of this provision, tax-exempt organizations were permitted

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[50] *Id.* (quoting David L. Thompson, Vice President of Public Policy for the National Council of Nonprofits, "[t]he codes are wonderfully generic when it comes to advertising and terribly cumbersome when it comes to rental space").
[51] *Id.*
[52] *Id.*
[53] *Id*
[54] *Guidance for Calculating UBTI for Tax Exempt Orgs*, CROWE (Aug. 30, 2018), https://www.crowe.com/insights/tax-news-highlights/guidance-for-calculating-ubti-for-exempt-orgs [https://perma.cc/XC8S-JUB5].
[55] Pub. L. 115-97, 131 Stat. 2169 (2017).
[56] 26 U.S.C. § 512(a)(7) (2012) (requiring inclusion of the three enumerated fringe benefits—QTFs, parking, and on-site athletic facility fringes—in unrelated business taxable income to the extent that they are not deductible by Section 274).
[57] In general, Section 132 operates to exclude from employees' gross incomes the fringe benefits described; the effect of Section 512(a)(7) is to shift the tax burden from the employee to employer. 26 U.S.C. §§ 132 and 512(a)(7); I.R.S. Notice 2018-67, 2018-36 I.R.B. 409.

to deduct the costs associated with providing these fringe benefits.[58] As a result, neither the direct beneficiary (i.e., employee) nor the provider (i.e., employer) of these benefits was taxed. The current provision treats exempt and non-exempt organizations equally with respect to these specific fringe benefits.[59]

However, the IRS seems to believe that including the fringe benefits in calculating UBIT does not subject these activities to the silo rule.[60] Accordingly, tax-exempt organizations are allowed to aggregate the incomes and deductions from all of these fringe activities.[61] Practitioners have identified at least three approaches employers may take in maintaining these benefits for employees: (i) continue to pay the fringe benefit and include the amounts paid as UBIT on Form 990-T; (ii) include the benefit as wages on the employees' Form W-2; or (iii) provide additional compensation to employees to cover the expenses.[62] We observe that to minimize the tax burden incurred in the provision of these fringe benefits, employers should include the benefits in their Form 990-T for employees, whose marginal rates exceed the corporate rate imposed on the exempt organizations, and charge as wages or increase compensation for those employees, whose marginal rates do not exceed the corporate rate.

Of particular concern to many exempt organizations is the treatment of the QTFs.[63] Under Section 512(a)(7), exempt organiza-

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[58] *Six Tax Reform Issues Impacting Nonprofit Organizations*, BDO: NONPROFIT STANDARDS (Mar. 29, 2018), https://www.bdo.com/blogs/nonprofit-standard/march-2018/six-tax-reform-issues-impacting-nonprofits [https://perma.cc/6ZPR-CPGH].

[59] *Id.*

[60] I.R.S. Notice 2018-99, 2018-52 I.R.B. 1067 ("The provision of QTFs that results in an increase in UBTI under § 512(a)(7) is not an unrelated trade or business . . . any increase in UBTI under § 512(a)(7) is not subject to § 12(a)(6).").

[61] *Id.*

[62] Petercsak & Bogda, *supra* note 19 (explaining the different approaches to complying with the new rule).

[63] On December 10, 2018, the IRS released interim guidance on the treatment of parking expenses for QTFs and received 483 comments by the end of the comment period on February 22, 2019. *Parking Expenses for Qualified Transportation Fringes under Section 274(a)(4) and Section 512(a)(7) of the Internal Revenue Code (Notice 2018-99)*. REGULATIONS.GOV, https://www.regulations.gov/docket?D=IRS-2018-0038 [https://perma.cc/G388-X233], (last visited April 1, 2019). *See also* Sally P. Schreiber, *IRS Explains Disallowance of Qualified Transportation Fringe Benefits for Parking*, J.

tions must increase unrelated business income to the extent that qualified transportation fringes and parking facilities used with qualified parking are not deductible under Section 274.[64] Section 274(a)(4) categorically disallows deductions for expenses of QTFs provided to the taxpayer's employees.[65] In complying with the new guidelines, practitioners have relied on a four-step method: (i) disallowance for reserved employee parking, (ii) primary use test, (iii) carve-out for reserved non-employee parking, and (iv) allocation based on typical usage.[66]

Under the first step, any parking spots reserved for employees are specifically included in the UBIT.[67] Under the primary use test, if over half of the spots are typically used by the general public, then the remaining spots are exempted from the Section 274 disallowance; if over half of the spots are typically used by employees, then the allocation of the UBIT must follow the remaining two steps in the four-step method.[68] Under the third step, any parking spots reserved for the general public are specifically exempted from the Section 274 disallowance.[69] Finally, the UBIT attributable to the remaining spots are allocated pro rata.[70] To illustrate, if sixty percent of the parking spots are typically used by employees but not reserved, then the tax-exempt organization must include sixty percent of its parking costs in

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ACCT. (Dec. 11, 2018), https://www.journalofaccountancy.com/news/2018/dec/irs-guidance-qtf-benefits-parking-201820258.html [https://perma.cc/Q5AV-P2HU] ("Under Sec. 274(a)(4), expenses incurred for providing parking to employees that are Sec. 132(f) qualified transportation fringes (QTF) are nondeductible by employers.").

[64] 26 U.S.C. § 512(a)(7) (2012).

[65] The general exclusion of $260 per month from gross income granted in § 132(f)(2) does not apply to employees described under this provision. 26 U.S.C. § 274(a)(4) ("No deduction shall be allowed under this chapter for the expense of any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer.").

[66] *Tax News Update: IRS Notice Provides Interim Guidance on Determining Tax Treatment of Qualified Transportation Fringe Benefits as Modified Under TCJA*, ERNST & YOUNG (Dec. 17, 2018), https://taxnews.ey.com/news/2018-2497-irs-notice-provides-interim-guidance-on-determining-tax-treatment-of-qualified-transportation-fringe-benefits-as-modified-under-tcja [https://perma.cc/BSV9-FATY].

[67] I.R.S. Notice 2018-99, 2018-52 I.R.B. 1067.

[68] *Id.*

[69] *Id.*

[70] *Id.*

its UBIT in addition to any specific costs for reserved employee parking.[71]

4. Comments

Commentators have raised other questions and concerns not addressed in the IRS Notice: for instance, may tax-exempt organizations aggregate gross incomes and deductions from unrelated trades or businesses that are "substantially similar?"[72] For example, if a university operates multiple parking lots, may the university aggregate the incomes and deductions from all of the parking lots as one trade or business?[73] Additionally, some nonprofit groups, such as the American Network of Community Options and Resources (ANCOR), have submitted comments to the IRS protesting the burdens that disallowances for the QTF would have on intellectual and developmental disability support providers, in particular.[74] They have requested a delayed implementation of the rule to allow such exempt organizations to prepare for compliance.[75]

C. NOL Deduction

In addition to the "silo" rule, the legislation has altered the treatment of NOL deductions.[76] Deductions for a taxable year are the lesser of (i) the aggregate of the NOL carryovers and carrybacks to such year, and (ii) eighty percent of taxable income without regard to the deduction allowed in Section 172.[77] This change prevents all organizations, not just tax-exempt ones, from taking deductions to below twenty percent of their gross income in a taxable year.[78] In

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[71] *Id.* (providing numerous examples of how the four-step method applies in different circumstances).
[72] Bell, *supra* note 26.
[73] *Id.*
[74] *ANCOR Comments to IRS on UBTI / UBIT / Parking Tax's Impact on I/DD Providers*, AM. NETWORK COMMUNITY OPTIONS & RESOURCES (Feb. 25, 2019), https://ancor.org/newsroom/news/ancor-comments-irs-ubti-ubit-parking-taxs-impact-idd-providers [https://perma.cc/RQ35-QZWR].
[75] *Id.*
[76] 26 U.S.C. § 172 (2012).
[77] *Id.* § 172(a).
[78] Some commentators have requested clarity on how this rule applies with post-2017 NOLs and pre-2018, which are not subject to the eighty percent

addition to a limitation on the amount of the deduction, the new law has generally eliminated carrybacks and allowed carryforwards for an indefinite time period.[79] This is a departure from the old law, which allowed companies to carryback up to two years and carryforward up to twenty years.[80] Coupled with changes to the corporate tax rate, this reduces the value of transferable NOLs.[81]

With the implementation of the silo rule, the IRS and commentators have expressed concerns about how NOLs will apply to different trades or businesses.[82] The IRS has taken the position that post-2017 NOLs will be treated analogously to post-2017 deductions, so that they will apply separately to each unrelated trade or business.[83] With respect to the NOL carryforwards, the commentators have wondered how such NOLs would be ordered—whether they would apply a traditional first in, first out approach.[84] In its notice, the IRS suggested that it will follow a last in, first out approach so that post-2017 NOLs will first be used to calculate UBIT, and then tax-exempt organizations will have the option to choose to apply their pre-2018 NOLs, which are not subject to the silo rule, against the total UBIT.[85]

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limitation. *See Guidance for Calculating UBTI for Tax Exempt Orgs*, *supra* note 54.

[79] The new law makes an exception for farming losses, which can carryback up to two years, and insurance companies, which are subject to the original two-year carryback and twenty-year carryforward. 26 U.S.C. § 172(b).

[80] John Owsley & John McKinley, *Carry Your Losses (Further) Forward*, J. ACCT. (May 1, 2018), https://www.journalofaccountancy.com/issues/2018/may/carry-forward-net-operating-losses.html [https://perma.cc/8FSH-HNUR] ("In general, prior to the TCJA, an NOL could be carried back up to two tax years and forward up to 20 tax years to offset taxable income.").

[81] KAREN LOHNES ET AL., TAX REFORM'S IMPACT ON DEALS, JOINT VENTURES, AND STRATEGIC ALLIANCES, Westlaw WGL-CTAX 54, 55 (recognizing "[r]educed benefit of tax attributes" including net operating losses as a buyer in mergers & acquisitions transactions).

[82] *See, e.g.*, I.R.S. Notice 2018-67, 2018-36 I.R.B. 409.

[83] *Id.*

[84] Bell, *supra* note 26, at 18 ("Do the traditional NOL rules requiring a first in, first out approach apply?").

[85] I.R.S. Notice 2018-67, 2018-36 I.R.B. 409 ("If § 512(a)(6) is read as an ordering rule for purposes of calculating and taking the NOL deduction, post-2017 NOLs will be calculated and taken before pre-2018 NOLs because the UBTI with respect to each trade or business is calculated under § 512(a)(6)(A) before calculating total UBTI under § 512(a)(6)(B).").

D. Partnerships and Funds

Despite the changes disfavoring exempt organizations participating in unrelated businesses or trades, the legislation has notably maintained the excludability of investment incomes, where the exempt organization assumes a more passive role.[86] IRS Notice 18-67 manifests the Treasury's and IRS's intent to allow aggregation of "investment activities" as one trade or business.[87] The interim rules create special treatment for UBIT generated in partnerships and multi-tiered funds.[88] In particular, the notice creates exceptions to aggregating UBIT if the exempt organization passes either one of two tests: (i) *de minimis* test, and (ii) control test.[89] The *de minimis* test limits an exempt organization's interest in capital or profits in the partnership interest to two percent.[90] The control test requires an exempt organization to hold less than twenty percent of the capital interest in the partnership, and to maintain no control or influence of the partnership's operations.[91] This ultimately allows participation in for-profit markets without burdensome administration and compliance.[92] These interim

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[86] 26 U.S.C. § 512(b) (2012) (excluding from gross income all: "dividends, interest, payments with respect to securities loans . . . amounts received or accrued as consideration for entering into agreements to make loans, and annuities").

[87] TODD LOWTHER & ADAM STERNBERG, RECENT DEVELOPMENTS: IRS ISSUES GUIDANCE ON UBTI FOR IDENTIFYING SEPARATE TRADES OR BUSINESSES 59–60 (2018), Westlaw 45 WGL-CTAX 59 ("Treasury and the IRS intend to propose regulations treating certain so-called 'investment activities' as one trade or business for purposes of Section 512(a)(6)(A). Under the anticipated guidance, exempt organizations would be permitted to aggregate all items of gross income and deduction related to such 'investment activities' . . . .").

[88] *Id.* (expressing intent to propose regulations that treat certain investment activities as one trade or business to ease administrative burdens on exempt organizations with "ownership interests in multi-tier partnership structures").

[89] *Id.* (describing two tests under Section 6 Interim and Transition Rules for Partnerships).

[90] I.R.S. Notice 2018-67, 2018-36 I.R.B. 409.

[91] *Id.*

[92] *Tax News Update*, *supra* note 66 ("The income from qualifying partnership interests permitted to be aggregated under the interim rule includes any unrelated debt-financed income arising in connection with the qualifying partnership interest that meets either the de minimis rule or the control rule . . . . This should streamline the related tax reporting and compliance functions for tax-exempt organizations that are invested in Funds.").

rules will remain in effect until regulations are finalized, and will allow tax-exempt organizations to aggregate UBIT from a single partnership interest that engages in multiples trades or businesses and aggregate UBIT from all qualifying partnership interests.[93]

While the notice addresses the issue of UBIT, exempt organizations must also consider whether participation in a partnership or joint venture would threaten its status as a tax-exempt entity.[94] After *Plumstead Theatre Society, Inc. v. Commissioner*[95] in 1980, the IRS has relied on a two-pronged test to determine whether an exempt organization may maintain its status in a joint venture.[96] The IRS considers (i) whether the joint venture furthers a charitable purpose, and (ii) whether the exempt organization can operate to exclusively for its exempt purpose and not for the benefit of its for-profit partners.[97] Without explicit indications to the contrary in the IRS Notice, we can anticipate that this standard for preserving exempt status will remain in effect.[98]

Even so, savvy tax-exempt investors have used structures to avoid realizing UBIT.[99] In the venture capital world, tax-exempt organizations and the venture capital funds have adopted the practice of inserting a "blocker" C corporation between the portfolio company and tax-exempt organization.[100] These blocker structures do not limit tax-paying obligations, but do help avoid the tax-exempt organiza-

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[93] I.R.S. Notice 2018-67, 2018-36 I.R.B. 409 ("[A]n exempt organization may aggregate its UBTI from its interest in a single partnership with multiple trades or businesses . . . .").

[94] Memorandum from Akin Gump Strauss Hauer & Feld LLP, Ron G. Nardini et al., To Partner or Not to Partner—It's an Exemption Question (Mar./Apr. 2018), https://www.akingump.com/images/content/6/5/v2/65423/Nardini-article.pdf [https://perma.cc/Y73W-KDZ4].

[95] *Plumstead Theatre Soc'y, Inc. v. Comm'r,* 74 T.C. 1324, 1334 (1980) (addressing how entities can lose tax-exempt status).

[96] *Id.*

[97] *Id.*

[98] *See generally* I.R.S. Notice 2018-67, 2018-36 I.R.B. 409.

[99] Gregg Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-Ups*, 70 HASTINGS L.J. 409, 421 (2019).

[100] *Id.* at 421–22 ("Tax-exempt investors generally avoid realizing unrelated business taxable income (UBTI), while foreign investors avoid income effectively connected with the United States . . . . To deal with the UBTI/ECI issue, VC funds interpose a 'blocker' C corporation into the structure between a partnership portfolio company and the UBTI/ECI-sensitive investors.").

tions' tax reporting obligation.[101] The existence of such structures clearly exposes the limitations of the new provision.[102]

E. Conclusion

Prompted in part by the Compliance Report and in general furtherance of promoting competition, the legislature has made several significant changes to the treatment of UBIT. By limiting exempt organizations' abilities to offset gains with losses from activities unrelated to the tax exempt purpose, eliminating carryback deductions for NOLs, and imposing equal treatment with respect to certain fringe benefits, the legislature has certainly curtailed the ability of exempt organizations from actively competing in for-profit enterprises. In light of other changes to the tax code, these changes seem to impair access to capital. In fact, some commentators have even suggested that this change in the tax code will yield a higher rate of mergers and alter the landscape of nonprofit work in the United States.[103] However, the preservation of rights to participate as passive investors under I.R.C. § 512(b) and lower corporate tax rates might be sufficient to offset any detrimental effects of the former substantive changes.

David Kim[104]

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[101] *Id.*
[102] *Id.*
[103] David Van Den Berg & Stephen K. Cooper, *Cash-Starved Nonprofits May Look to Merge in Wake of the TCJA*, TAX NOTES (June 4, 2018), https://www.taxnotes.com/tax-notes/exempt-organizations/cash-starved-nonprofits-may-look-merge-wake-tcja/2018/06/04/283c3?highlight=transportation%20fringe%20benefit%20study ("The expectation of shrinking charitable donations . . . could prompt mergers among nonprofit organizations").
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