Retirement **Spotlight**

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IRS Regulations Address Tax on Unrelated Businesses in Plans

The IRS has released final regulations on computing unrelated business taxable income (UBTI) for a tax-exempt organization. This guidance may affect only a relatively small portion of tax-exempt retirement plans. For those plans that invest in certain types of assets, however, knowing the rules will be important. As explained later, these final regulations may help simplify administration and reporting requirements for what are usually considered to be more complex investments.

The final regulations pertain to Internal Revenue Code Section (IRC Sec.) 512(a)(6), added by the Tax Cuts and Jobs Act of 2017. The regulations are generally effective for taxable years starting on or after December 2, 2020. Tax-exempt organizations may choose to apply the final regulations to taxable years that start on or after January 1, 2018. Alternatively, they may rely on a "reasonable, good-faith interpretation" of IRC Sec. 512(a)(6) for such taxable years.

Rationale for the Unrelated Business Tax

IRC Sec. 501(c) contains the list of exempt organizations that receive special tax benefits. Perhaps most familiar to many are IRC Sec. 501(c)(3) entities, which are organized and operated for religious, charitable, scientific, educational, and other similar purposes. Because of the societal benefits that these organizations confer, they are exempt from federal taxation. Hence the name "exempt organizations".

Because these exempt entities operate free from most taxation, they can devote more of their resources to their purpose. Some organizations own or operate businesses outside this purpose, usually to raise money to further the organization's goals. But this could allow them to have an advantage over for-profit organizations conducting the same kind of business.

- **Example:** Misty Meadows Arboretum is an IRC 501(c)(3) exempt organization whose primary purpose is to educate the community about various ecosystems. It relies primarily on charitable contributions from its members. It always has a spring plant sale, which is open to the public and brings in a modest profit. Misty Meadows' new director sees potential in creating a larger plant sale. Eventually, the arboretum builds multiple greenhouses to meet the huge demand. Before long, the annual plant sale is by far Misty Meadows' biggest revenue source. Unfortunately, Misty Meadows' director wasn't aware that the arboretum was prohibited from using its tax-exempt status to run the almost year-round plant-sales operation without paying any tax.

Exempt organizations that operate a business enterprise outside their tax-exempt purpose are required to pay taxes on profits from that enterprise. This levels the playing field so that not-for-profit entities do not have an unfair advantage, which would be contrary to public policy.

Retirement Plans as Exempt Organizations

In addition to the UBTI rules applying to IRC 501(c)(3) organizations, they also apply to trusts under IRC Sec. 401(a). This includes pension plans, profit sharing plans, and 401(k) plans. The IRS also applies the UBTI rules to IRAs.

In the vast majority of plans and IRAs, UBTI will not be a factor. Generally, most assets in these types of plans are invested in mutual funds or time deposits (i.e., certificates of deposit). Even participants in plans that permit greater investment latitude will often invest in individual securities. Only those plans that permit true investment self-direction will normally become subject to the UBTI rules. The plans most often associated with unrelated taxable businesses are truly self-directed owner-only 401(k) plans and IRAs. These types of accounts are referred to as self-directed accounts or SDAs. And while some financial organizations may permit SDA owners to place assets in investments that generate UBTI, many SDA investments (e.g., precious metals, promissory notes) do not.

How Does the Tax on UBTI work?

The rules on UBTI can be complex, but here are some of the basics.

- **Annual income of $1,000.** Form 990-T: *Exempt Organization Business Income Tax Return,* must be filed for plans with gross income of $1,000 or more from an unrelated trade or business. Form 990-T must normally be filed for qualified plans and IRAs by the trust's tax return due date (generally April 15 for calendar-year tax filers).

- **Tax rates.** A filer gets a $1,000 "specific deduction." So an IRA with exactly $1,000 in gross income from an unrelated business would have to *file* Form 990-T, but it doesn't *pay tax* on the income unless there is UBTI after the $1,000 deduction (and any other deduction) is applied. The tax rate schedule for trusts then applies for any taxable unrelated business income. This rate starts at 10 percent—but quickly rises to 37 percent (on taxable income over $12,950).

- **Filing Form 990-T.** This is one of the biggest concerns surrounding SDAs: who is responsible for actually filing Form 990-T? The Form 990-T instructions state that the exempt organization (e.g., the 401(k) plan) and the trustee or custodian of the IRA must file. Practically, the financial organization may address this requirement by clarifying (in a service agreement) that the account owner must *prepare* any Form 990-T that is needed, while the financial organization (as trustee or custodian) will *file it* with the IRS. It is important that both parties understand their roles. The financial organization may not know enough of the details about the underlying investments to prepare Form 990-T, but the account owner may assume that, because the financial organization is allowing self-directed investments, it is also taking care of every aspect of such investments. Unless financial organizations are charging for providing this service, it is unlikely that they will volunteer to do it. And if they agree to prepare Form 990-T, they must have access to sufficient information. This is but one reason that financial organizations must carefully consider whether they wish to offer self-directed accounts. If they do, they should ensure that their clients clearly understand their respective roles and duties.

NOTE: *Any financial organization allowing—and any individual owning—retirement plan investments that require Form 990-T filing should consult with a competent tax adviser.*

Specific Provisions in the Final Regulations

The regulations contain provisions that may affect how unrelated businesses operate within a retirement plan.

- **Multiple unrelated businesses are treated separately.** The final regulations require an exempt organization subject to the unrelated business income tax—if it has more than one unrelated trade or business—to calculate UBTI separately for each one. But the rule also prohibits offsetting the income of one unrelated business with the net operating loss of another. Using the example above, let's consider how the new rules would dictate how the arboretum would report UBTI if it decided to build and operate a restaurant to increase its income.

  The final regulations require an exempt organization to identify each separate business using the first two digits of the North American Industry Classification System (NAICS) code. The NAICS code (pronounced "nākes") is a six-digit system that classifies over one thousand industries. The first two digits identify the general sector of the business (e.g., construction, manufacturing, education). Each successive digit narrows the business definition. In our example, for instance, the arboretum's greenhouse operation could be classified with the first two digits "45," which identifies "Retail Trade"; the restaurant would be classified under "Accommodation and Food Service," which is "72." If multiple businesses have the same first two digits, they are not considered separate businesses of the exempt organization. If the digits are different, they must file a separate Form 990-T schedule for each business with gross income of at least $1,000. In addition, one unrelated business cannot reduce its tax obligation by using the net operating loss (NOL) of another. So if the arboretum's greenhouse made a profit, it could not reduce its taxes by using the restaurant's NOL. Each "separate" unrelated business must stand on its own.

- **Unrelated businesses in the nature of investments.** An exempt organization may be permitted to treat various investments that are subject to UBTI as one distinct unrelated trade or business. This allows the organization to invest in multiple unrelated businesses that can be combined for UBTI purposes into one "business" classified as *investment activity*. The regulations limit such investments to
    - qualifying partnership interests (QPI),
    - qualifying S corporation interests (QSI), and
    - debt-financed properties.

  An exempt organization may identify "investment activities" on its Form 990-T (Schedule A)—using a six-digit non-NAICS code rather than the two-digit NAICS code. But it can classify multiple unrelated investments as investment activity on one Schedule A *only* if each of the investments is one of the types just mentioned. The organization has a QPI in an unrelated trade or business if the organization
    - is *not* a general partner in the partnership, *and*
    - either holds no more than a 2 percent interest in the profits or capital, *or* holds no more than 20 percent of the capital interest and does not significantly participate in the partnership.

  The regulations contain similar rules for a QSI. But instead of using the term "profits or capital interest," the tern "stock ownership" is used. So for investments in both partnerships and S corporations, exempt organizations with limited ownership and involvement can combine such investments into one unrelated business classified as "investment activity." This approach gives exempt organizations more investment flexibility by reducing their need to obtain information from entities they invest in—information that may be harder for a small investor to readily obtain.

  Debt-financed properties are likely to be included in this investment activity category because special UBTI rules already apply to such properties. Grouping other investments together may be a practical way for the IRS to simplify Form 990-T filing, thus ensuring greater compliance.

Practical Impact on Retirement Plans

The only specific plan provision in the final regulations—adopted without change from the proposed regulations—merely codified a rule that the IRS has operated under for years. This addition clarifies that the definition of unrelated trade or business for trusts (such as qualified retirement plan trusts) also applies to IRAs.

Other than that, the effects on plans, if they apply at all, are likely minor. But they are still important. Consider a self-directed account owner, for example, who has invested in a debt-financed rental property and has also bought (at arm's length) a very small interest in a partnership (a QPI). Historically, if each investment generated at least $1,000 in gross income, each would be reported as a separate business (with a separate Form 990-T schedule). Now it is clear that multiple investments can be more easily grouped into one classification: investment activities. And to the extent that different investments in a plan can be aggregated, there is less concern about the new limitation on NOLs reducing profits in another unrelated business. Most SDAs will simply require a Form 990-T with a single Schedule A that accounts for all their unrelated business investments.

Conclusion

Although these regulations may have little effect on retirement plans, those who work with self-directed retirement plans should consider the following questions.

- Do any of my plans contain investments that may generate UBTI?
- If so, do I know who is responsible for filing IRS Form 990-T? While a financial organization that operates in the self-directed account sector may file this form routinely (when needed), it may be worth verifying what the trust agreement or other controlling documents state.

- Does the entity filing Form 990-T know about the details of the final regulation? While the implications of the final regulations are relatively minor, knowing the details can still be helpful.

The IRS has released a *draft* version of the updated Form 990-T (and instructions), which contain details on the filing requirements mentioned in the final regulations.

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