ROPES & GRAY ALERT

Tax-Exempt Organizations

August 23, 2018

IRS Issues Guidance on UBTI Silos and Other UBTI-Related Tax Reform Provisions

In Notice 2018-67, issued August 21, 2018 (the "Notice"), the IRS has provided interim guidance – including rules on which tax-exempt organizations may rely pending proposed regulations – on aggregation of activities under the new unrelated business taxable income (UBTI) "silo" rule. The Notice also addresses other issues related to the silo rule, including debt-financed UBTI, net operating loss (NOL) ordering rules, the new fringe benefit UBTI rule, and the new global intangible low-taxed income (GILTI) inclusions.

The UBTI Silo Rule. Section 512(a)(6) of the Code, enacted by the Tax Cuts and Jobs Act in December 2017, requires a tax-exempt organization to compute UBTI separately with respect to each unrelated trade or business of the organization, effective for tax years beginning after December 31, 2017. The new rule in general prevents tax-exempt organizations from offsetting UBTI generated by a profitable unrelated trade or business with a loss from an unprofitable one. However, the statute left unclear the scope of the activities that could be grouped together as a single unrelated trade or business.

"Reasonable, Good-Faith Interpretation" Standard. The Notice permits tax-exempt organizations to "rely on a reasonable, good-faith interpretation" of Sections 511-514 of the Code in determining whether they have more than one unrelated trade or business, pending issuance of proposed regulations. A good-faith interpretation must consider all the facts and circumstances. The IRS has requested comments on possible methods to identify separate trades or businesses; however, the Notice also states the IRS will consider an organization's groupings of activities to be reasonable and in good faith if the organization uses the 6-digit codes of the North American Industry Classification System (NAICS). The NAICS is a standard used by Federal agencies to classify businesses for statistical purposes, and IRS Form 990-T requires organizations to list one or more codes based on the NAICS list to describe their unrelated trade or business activities.

Interim and Transition Rules for Partnership Investments. In addition to the general reasonable, good-faith standard, the Notice provides two reliance rules specifically for aggregating partnership interests and activities for purposes of the UBTI silo rule, acknowledging the administrative burden associated with investments in multi-tier partnership structures.

> "Interim Rule": Aggregate all "Qualifying Partnership Interests." Until proposed regulations are issued, a tax-exempt organization may treat a "qualifying partnership interest" as a single trade or business (even if the partnership is engaged, directly or indirectly through underlying partnerships, in multiple trades or businesses), and may further aggregate all of its qualifying partnership interests together as a single trade or business. In order to be a qualifying partnership interest, a partnership interest must meet the requirements of either the "*de minimis*" test or the "control" test.
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> - *De minimis* test: The *de minimis* test is met if a tax-exempt organization holds directly no more than two percent of the profits interest and no more than two percent of the capital interest in the partnership. If no specific profits interest is identified in Schedule K-1, the *de minimis* test is not met.
> - Control test: The control test is met if a tax-exempt organization holds no more than 20 percent of the capital interest in, and, based on all the facts and circumstances, does not have control or influence over,

the partnership. The application of this control or influence standard is unclear; for example, it is unclear whether membership on a limited partner advisory committee (LPAC) may constitute control or influence. The Notice does not specify whether the organization is eligible under the control test if Schedule K-1 does not specify the organization's percentage interest.

For both tests, the interest of a disqualified person, a supporting organization, or a controlled entity (within the meaning of Section 512(b)(13)) in the same partnership will be taken into account in determining the tax-exempt organization's percentage interest.

"Transition Rule": Treat Each Current Holding as One Trade or Business. Regardless of whether the *de minimis* test or control test is met, a tax-exempt organization may treat a partnership interest acquired prior to August 21, 2018 as constituting a single trade or business, whether or not the partnership directly or indirectly conducts more than one trade or business. These partnership interests are not "qualifying partnership interests" and therefore are not automatically eligible for aggregation with other interests; however, they may be eligible for aggregation with other interests under the general good-faith reasonable grouping standard discussed above. The Notice does not specifically state whether capital contributions made subsequent to August 21 affect a partnership's eligibility to qualify under the transition rule.

Practical Implications. In practical terms, the interim rule would permit an organization to aggregate all private investment fund interests for funds in which it holds no more than 20% of the fund's capital and over which it does not have control or influence. "Funds of one," direct investments and certain joint ventures, by contrast, may qualify only for the transition rule permitting each partnership interest to be treated as comprising a single trade or business, and may not be covered by either the interim or the transition rule if acquired on or after August 21, 2018. However, it may be possible to group transition rule-eligible interests or newly acquired partnership interests with other activities into a single trade or business under the general, good-faith interpretation rule described above.

Other Issues

Aggregation of Debt Financed Income. The Notice states that a tax-exempt organization may aggregate unrelated debt-financed income from a qualifying partnership interest with other UBTI from its qualifying partnership interests, and may aggregate unrelated debt-financed income from a transition rule-eligible partnership interest with other unrelated business income or loss from that partnership interest. The Notice does not address the treatment of debt-financed income outside the partnership context.

Ordering of Net Operating Losses. NOLs generated in taxable years beginning before January 1, 2018 may be used in subsequent years with no siloing limitation. However, because UBTI must be calculated separately for each trade or business before calculating total UBTI for taxable years beginning on or after January 1, 2018, it appears post-2017 NOLs should be calculated and taken before pre-2018 NOL carryovers are taken. However, if read as imposing such an ordering rule, Section 512(a)(6) could lead to the expiration of unused pre-2018 NOLs that remain subject to 20-year expiration under prior law. The Notice requests comments on this issue and any other issues relating to the interaction of Section 512(a)(6) with Section 172, but does not provide guidance.

Transportation and Parking Fringes. The Tax Cuts and Jobs Act enacted new Section 512(a)(7), which requires tax-exempt organizations to include as UBTI costs incurred associated with providing certain employee fringe benefits. The Notice states that while Section 512(a)(7) imposes UBTI, the IRS does not consider providing employee transportation or parking benefits to be an unrelated trade or business, and therefore UBTI arising from these fringe benefits under Section 512(a)(7) is not subject to the Section 512(a)(6) silo rule.

Global Intangible Low-Taxed Income (GILTI). The Notice states that GILTI income inclusions under new Section 951A of the Code are treated as dividends, and are not treated as UBTI unless they constitute debt-financed income under Section 512(b)(4). In addition, GILTI income inclusions attributable to insurance income will not be treated as UBTI unless provided otherwise in proposed regulations.

Comments Requested. The Notice also outlines the current thinking of the Treasury and IRS relating to the contents of proposed regulations to be issued in the future on these issues, and requests public comments. Comments should be submitted on or before December 3, 2018.

While the Notice provides clarity on certain of the issues presented by the UBTI silo rule and the other issues discussed above, the guidance provided in the Notice is complex and leaves some questions unanswered. If you have any questions about the Notice or tax reform more generally, please contact a member of the tax group or the tax-exempt organizations practice.