April 28, 2020

Unrelated Business Taxable Income "Silo" Regulations Released

On April 23, 2020, the Department of the Treasury and Internal Revenue Service released long-awaited proposed regulations (REG-106864-18) providing guidance on the unrelated business taxable income ("UBTI") "silo" rule. Section 512(a)(6) of the Internal Revenue Code, enacted as part of the tax reform package commonly known as 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 rule in general prevents 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 activities that could be grouped together as a single unrelated trade or business – an issue that determines, in large part, the burden an organization faces in implementing the silo rule.

The Proposed Regulations generally are consistent with guidance issued by the IRS on the silo rule in August 2018 (Notice 2018-67, the "Notice"), but depart from the Notice in certain key respects, described further below. Additionally, the Proposed Regulations provide guidance on a number of other issues related to Section 512(a)(6), including the interaction between Section 512(a)(6) and net operating losses, the allocation of deductions among various activities, and the effect of Section 512(a)(6) on public support determinations.

General Silo Rule – NAICS Two-Digit Code Classification

The Proposed Regulations require organizations to identify and group their unrelated trades or businesses other than specifically defined "investment activities" using the North American Industry Classification System ("NAICS"). Acceding to feedback from commenters, however, the Proposed Regulations generally require organizations to separate their activities only into the 20 NAICS sectors identified by 2-digit NAICS codes, rather than into more specific categories identified by over 1,000 6-digit NAICS codes, as the Notice had proposed as a safe harbor. Use of the NAICS 2-digit codes, rather than the NAICS 6-digit codes, thus allows organizations to group together a broader range of activities into a single unrelated trade or business than had been contemplated by the Notice.

The Proposed Regulations also clarify that each NAICS 2-digit code is to be reported only once, with all activities under that code treated as a single silo. For example, an organization operating multiple retail pharmacies constituting unrelated trades or businesses would calculate and report aggregate UBTI generated by the pharmacies under the single NAICS 2-digit code for "retail trade." Once an organization has assigned a particular unrelated trade or business to a NAICS sector in its first Form 990-T filed after the regulations are finalized, it generally may not change that activity's sector code.

Special Silo Rule for Investment Activities

Under the Proposed Regulations, an organization's "investment activities" are treated as one silo, separate from the organization's other activities that are grouped using NAICS 2-digit codes. However, investment activities, for these purposes, are limited to three activities expressly listed in the Proposed Regulations: qualifying partnership interests ("QPIs"), debt-financed properties, and qualifying S corporation interests. Therefore, any other activities, even if the organization considers them to be in the nature of investments, remain subject to the general silo rule described above and must be classified based on NAICS 2-digit codes.

Qualifying Partnership Interests

Optional aggregation of QPIs. The Proposed Regulations permit, but do not require, an organization to aggregate its UBTI derived from all partnership interests qualifying as QPIs, together with its other specifically defined investment activities, in a single silo. An organization desiring to treat a QPI as part of its investment activities designates the interest as a QPI by aggregating the income and expenses derived from the QPI with the income and expenses from its other investment activities. Once an organization designates a partnership interest as a QPI, it must continue to treat the interest as a QPI until the interest fails to qualify as such. If a partnership interest is not (or is not designated as) a QPI, the organization must group the trades or businesses conducted by the partnership (whether directly or indirectly through other partnerships that are not treated as QPIs) using the NAICS 2-digit codes (subject to the "transition rule" discussed below).

***De minimis* test.** As under the Notice, a partnership interest will be a QPI under the Proposed Regulations if it meets either a *de minimis* test or a control test. No partnership in which the organization is a general partner may be a QPI. A partnership interest meets the *de minimis* test if the organization directly holds (1) no more than 2% of the profits interests and (2) no more than 2% of the capital interests in the partnership. Departing from the Notice, the Proposed Regulations consider only the interest held by the organization for purposes of the *de minimis* test and do not require aggregation with interests held by any related individuals or organizations.

Control test. A partnership interest meets the control test if the organization (1) does not hold more than 20% of the capital interests in the partnership and (2) does not control the partnership. Treasury and the IRS expressly retained the 20% threshold under the control test despite comments that an organization may hold a greater-than-20% interest in a partnership solely for investment purposes. As under the Notice, interests in the same partnership held by Section 509(a)(3) supporting organizations and Section 512(b)(13) controlled entities of the organization must be aggregated with the organization's holdings for purposes of the 20% test. Interests in the same partnership held by Section 509(a)(3) supporting organizations and Section 512(b)(13) controlled entities of the organization must be aggregated with the organization's holdings for purposes of the 20% test. Unlike under the Notice, however, the Proposed Regulations do not require an organization to aggregate its holdings with interests held by its disqualified persons, such as officers, directors, and trustees.

Whether an organization controls a partnership is based on a facts and circumstances test. Notably, the Proposed Regulations limit this test to "control" over the partnership, whereas the Notice referred to "control or influence." Certain specific circumstances are treated as per se establishing control over a partnership: (1) the organization, by itself, may require the partnership to take (or fail to take) actions that significantly affect the partnership's operations, (2) any of the organization's officers, directors, trustees, or employees have management participation rights or rights to conduct the partnership's business, or (3) the organization, by itself, may appoint or remove any of the partnership's officers or employees, or a majority of directors.

"Look-through" rule for *de minimis* test. Under a new "look-through rule," if an organization holds a less than 2% profits and capital interest in a partnership (the indirectly held interest) through another partnership in which the organization holds more than a 20% capital interest, but which the organization does not control, the indirectly held interest may still be treated as a QPI. As with directly held QPIs, an organization is permitted, but not required, to aggregate its income from such indirectly held QPIs with its income from directly held QPIs and other investment activities. Once designated as an indirectly held QPI, an interest must continue to be treated as part of the organization's investment activities until it no longer qualifies as a QPI.

Reliance on Schedule K-1 for percentage interests. An organization may rely on a Schedule K-1 to determine the organization's percentage interest for purposes of the *de minimis* or control test only to the extent the Schedule K-1 specifically lists the organization's percentage profits interest and percentage capital interest at both the beginning and end of the year. If so provided, the organization will use the average of its percentage interest at the beginning of the year (or, if later, its ownership period) and the end of the year. The Proposed Regulations do not provide guidance on how the organization determines its percentage interest in a situation in which the organization's Schedule K-1 does not report its percentage interest.

"Transition rule" for investments acquired before August 21, 2018. The Proposed Regulations largely retain the "transition rule" set out by the Notice, which permitted an organization to treat a partnership interest acquired prior to August 21, 2018 as a single trade or business, regardless of the partnership's activities and without regard to the QPI tests. The Proposed Regulations clarify that such partnership interests will continue to fall under the transition rule even if the organization's percentage interest changes on or after August 21, 2018. An organization can rely on the transition rule until the first day of its first taxable year beginning after the Proposed Regulations are published as final regulations in the Federal Register. For each partnership interest that is eligible to meet either the transition rule or the look-through rule for indirectly held interests, the organization may apply only one of the two rules.

Unrelated Debt-Financed Income

The Proposed Regulations include in "investment activities" all UBTI derived from an organization's debt-financed property within the meaning of Section 514. This is a departure from the Notice, which provided that an organization should include debt-financed income arising from a partnership interest together with other UBTI generated by that partnership interest, and did not address debt-financed income from activities other than partnerships. Treasury and the IRS caution, however, that amounts generated from debt-financed property that constitute UBTI under Section 512 without regard to the presence of debt financing (e.g., rent from property more than 50 % of which is attributable to personal property or rent from real property where services are also provided) do not constitute income from debt-financed property for this purpose and therefore must be grouped by reference to the applicable NAICS 2-digit codes.

S Corporation Interests

Under the Proposed Regulations, each interest an organization holds in an S corporation will be treated as a separate unrelated trade or business. However, an organization may aggregate UBTI from any S corporation interest with its UBTI from other investment activities if the organization's stock ownership (by percentage of stock ownership) in the S corporation meets the percentage ownership criteria for a QPI under either the *de minimis* or control tests and, with respect to the control test, the organization does not control the S corporation based on all the facts and circumstances. The organization may rely on a Schedule K-1 for purposes of determining its stock ownership for these purposes.

Treatment of Specified Payments from Controlled Entities and Subpart F Income of Controlled Foreign Corporations

An organization is permitted to aggregate all specified payments (interest, annuities, royalties, and rents) received from a single Section 512(b)(13) controlled entity as one separate unrelated trade or business. If a controlling organization receives specified payments from two different controlled entities, the organization must treat such payments as arising from two unrelated trades or businesses, each comprising the payments from one entity.

With respect to controlled foreign corporations ("CFCs"), all Subpart F insurance income included in UBTI under Section 512(b)(17) will be treated as income derived from a single separate trade or business, meaning that an organization is permitted to aggregate the income derived under Section 512(b)(17) from multiple CFCs. However, an organization cannot aggregate insurance income included under Section 512(b)(17) with any commercial-type insurance activities conducted directly by the organization, or with income from investment activities.

Effective Date

The Proposed Regulations are effective for the first taxable year following the date on which final regulations are published in the Federal Register. For taxable years beginning before the date the Proposed Regulations are finalized, an organization may rely on the Proposed Regulations in their entirety. An organization may alternatively rely on the methods of aggregating and identifying separate trades or businesses described in the Notice or on a reasonable, good-faith interpretation of Sections 511 through 514, considering all the facts and circumstances.

In addition to providing rules for the grouping of activities for purposes of the silo rule, the Proposed Regulations address a number of other issues related to Section 512(a)(6).

Ordering of Net Operating Losses

The Proposed Regulations provide some clarification on the treatment of net operating losses ("NOLs") arising prior to and following the effective date of Section 512(a)(6). NOLs arising in taxable years beginning on or prior to December 31, 2017 ("pre-2018 NOLs") are not subject to the silo rule of Section 512(a)(6) and thus can be used to offset UBTI from any of an organization's unrelated trade or business activities. Such pre-2018 NOLs, however, are subject to carry-forward limitations, including expiration, which do not apply to NOLs arising in taxable years beginning after December 31, 2017 ("post-2017 NOLs"). The Proposed Regulations provide that an organization with both pre-2018 NOLs and post-2017 NOLs must deduct its pre-2018 NOLs from total UBTI before deducting any post-2017 NOLs from an unrelated trade or business against the UBTI from such trade or business. Pre-2018 NOLs are to be taken into account in the manner that results in maximum utilization of the pre-2018 NOLs. Treasury and the IRS are still considering the interaction between the silo rule and the Coronavirus Aid, Relief, and Economic Security Act (commonly known as the "CARES Act"), pursuant to which NOLs arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, may generally be carried back to each of the five years preceding the taxable year in which the NOL arose.

Allocation of Directly Connected Deductions

The Proposed Regulations provide guidance on how organizations are to allocate deductions among different unrelated trades or businesses. The Proposed Regulations incorporate the existing standard for allocating deductions between related activities and unrelated trade or business activities described in the Treasury Regulations, which require a reasonable basis for allocating deductions to separate unrelated trades or businesses. Treasury and the IRS recognize that a reasonableness standard is difficult to administer and intend to address this issue further in a separate rulemaking project. The Proposed Regulations provide, however, that use of the unadjusted gross-to-gross method (which allocates expenses based on relative gross receipts) is not a reasonable method.

Inclusions of Subpart F Income and Global Intangible Low-Taxed Income ("GILTI")

The Proposed Regulations confirm that Subpart F and GILTI inclusions are treated in the same manner as dividends for purposes of determining UBTI under Section 512(b)(1). Therefore, except for Subpart F insurance income includible in UBTI under Section 512(b)(17), Subpart F and GILTI income are not subject to siloing or other UBTI rules (unless separately includible as unrelated debt-financed income).

Social Clubs, Voluntary Employees' Beneficiary Associations ("VEBAs"), and Supplemental Unemployment Benefits Trusts ("SUBs")

Social clubs, VEBAs, and SUBs are generally required to classify their unrelated trades or businesses based on the generally applicable rules set out by the Proposed Regulations, including those for investment activities. Such entities must also include in investment activities certain amounts that are excluded as UBTI for other tax-exempt organizations, including interest, dividends, royalties, rents, and capital gains, as well as amounts attributable to income that are set aside but not used for certain purposes. The Proposed Regulations provide special rules for such income.

Social clubs, specifically, are not eligible for the transition rule or interim rule set out by the Proposed Regulations or the Notice.

Total UBTI and the Public Support Tests

The Proposed Regulations indicate that the silo rule does not apply for purposes of public support test calculations under Sections 509(a)(1) and 509(a)(2). Therefore, an organization with multiple unrelated trades or businesses is permitted to aggregate its net income and net losses from all such unrelated business activities for purposes of calculating its public support.

Comments Requested

Treasury and the IRS have requested comments on many specific issues and on the Proposed Regulations generally. All comments must be submitted by June 23, 2020.

For more information, please contact a member of the tax-exempt organizations practice.