December 22, 2020

Final Unrelated Business Taxable Income "Silo" Regulations Released

IRS Largely Retains Rules Proposed in April 2020

On November 19, the Department of the Treasury and the Internal Revenue Service released final regulations (the "Final Regulations") providing guidance on the unrelated business taxable income ("UBTI") "silo" rule. The Final Regulations were published in the Federal Register on December 2. 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, but the statute left unclear how activities should be grouped into trade or business silos.

The Final Regulations generally are consistent with proposed regulations issued in April 2020 (the "Proposed Regulations"), which were summarized in a previous alert. In particular, the Final Regulations retain the 20% ownership limit applicable for determining whether a partnership investment may be aggregated together with other qualifying partnership interests in the organization's "investment activities" silo. The Final Regulations provide organizations with incrementally more flexibility by looking through tiers of partnerships and disregarding certain rights commonly provided to limited partners in partnerships when determining whether a partnership interest can be included in the investment activities silo. The Final Regulations clarify the guidance provided in the Proposed Regulations relating to the interaction between the silo rule and net operating losses, and adopt without substantial change the Proposed Regulations relating to allocation of deductions among various activities, treatment of Subpart F and GILTI income as dividends (and therefore generally excluded from UBTI), interaction between the silo rule and the public support tests under Section 509, treatment of debt-financed UBTI and UBTI from controlled foreign corporations and controlled entities, and rules applicable to social clubs, voluntary employees' beneficiary associations ("VEBAs"), and supplemental benefits trusts ("SUBs").

NAICS Codes

The Proposed Regulations required organizations to identify and group their unrelated trades or businesses other than specifically defined "investment activities" using the North American Industry Classification System ("NAICS"), and generally required organizations to separate their activities into the 20 NAICS sectors defined by two-digit codes. The Final Regulations retain the use of NAICS two-digit codes.

In response to requests from commentators for additional guidance regarding how to choose the most accurate NAICS two-digit code, the Final Regulations clarify that the determination of which NAICS two-digit code most accurately describes a trade or business activity is based on the more specific six-digit code that best describes the activity. Furthermore, the Final Regulations clarify that the descriptions in the NAICS manual are relevant to this determination.

The Final Regulations also remove the restriction in the Proposed Regulations that would have prohibited an organization from changing its NAICS two-digit code unless it showed that (a) the code chosen was due to unintentional error and (b) another code more accurately described the unrelated trade or business. Instead, the Final Regulations simply require that the organization report a change on Form 990-T in the taxable year in which it occurs (including a change in identification of a separate unrelated trade or business with respect to a partnership interest that was incorrectly designated as a qualifying partnership interest).

Qualifying Partnership Interests

An organization is permitted, but not required, to aggregate in a single silo, together with its other investment activities, UBTI derived from all of its investments in ”qualifying partnership interests” (“QPIs”). This aggregation rule relieves the organization from having to determine whether it is engaged in more than one trade or business activity as a result of the activities of a single investment partnership. It also permits the organization to treat the aggregate group of all QPIs, together with any debt-financed property or properties, as a single “investment activities” trade or business. The preamble to the Final Regulations emphasizes that, rather than being a recognition that an organization’s investment activities are fundamentally a single activity for purposes of Section 512(a)(6), as some commentators had argued, the QPI rule is intended as an administrative convenience for exempt organizations based on a view that organizations cannot easily obtain information regarding the trade or business activities of lower-tier partnerships in which they hold relatively small interests.

Under the Final Regulations, as under the Proposed Regulations, a partnership interest may be treated as a QPI if it meets the requirements of either (i) the *de minimis* test or (ii) the participation test (called the “control” test under the Proposed Regulations).

- 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.

- A partnership interest meets the significant participation test if the organization (1) does not hold more than 20% of the capital interests in the partnership and (2) does not significantly participate in the partnership.

The Proposed Regulations had enumerated four *per se* factors that would cause a partnership interest to fail the control test, but otherwise required the organization to determine whether it controlled each partnership based on all the facts and circumstances. The Final Regulations retain the four *per se* factors but discard the general facts and circumstances test as too uncertain and too difficult to administer. Accordingly, an organization is treated as significantly participating in the activities of the partnership if:

- The organization, by itself, may require the partnership to perform, or may prevent the partnership from performing any act that significantly affects the operations of the partnership;

- Any of the organization’s officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time;

- Any of the organization’s officers, directors, trustees, or employees have rights to conduct the partnership’s business at any time; or

- The organization, by itself, has the power to appoint or remove any of the partnership’s officers or employees, or a majority of its directors.

In response to comments, the Final Regulations clarify that an organization is not treated as able to require the partnership to perform or prevent the partnership from performing an act solely as a result of a unanimous voting requirement or through minority consent rights. However, the IRS declined to modify the second and third *per se* factors, which may prevent an organization from treating a partnership interest as a QPI solely because one of its directors or trustees is affiliated with the sponsor of the partnership. The IRS also declined to accept a suggestion from commentators to include a list of powers that do not indicate significant participation, such as membership on an advisory committee and customary consent, waiver, veto/and or amendment rights with respect to amendments of the partnership agreement, but stated in the preamble to the regulations that an organization need not consider any rights or powers other than the four *per se* factors to determine whether the organization has significantly participated in a partnership, eliminating the need for such a list.

Look-Through Rule. The Final Regulations adopt a look-through rule that allows an organization to determine that an indirectly held partnership interest qualifies as a QPI based on the indirectly held interest meeting either the *de minimis* or significant participation test. However, for purposes of the significant participation test, instead of simply calculating the organization's indirect percentage interest in the indirectly held partnership, the Final Regulations appear to require that the directly held partnership itself own 20% or less of the indirectly held partnership. This reduces the utility of the look-through rule in certain common situations, like private investment funds with multiple "feeder" funds.

Combining Related Interests. In general, an organization must aggregate its interest in a partnership together with interests held by certain related persons and organizations. In response to comments, the Final Regulations exclude Type III supporting organizations from the scope of related organizations covered by this rule, other than in cases where the Type III supporting organization is the parent entity of the supported organization.

Grace Period. The Final Regulations adopt a limited grace period rule that permits a partnership interest that fails to meet either the *de minimis* or significant participation test because of an increase in the organization's percentage interest during a taxable year due to the redemption or other action of another partner to be treated as meeting the requirements for QPI status if the applicable test was met during the prior taxable year.

Transition Rule. The transition rule included in Notice 2018-67 and the Proposed Regulations, which permitted an organization to treat any partnership interest acquired prior to August 21, 2018 as a single trade or business activity, will lapse as of the first day of the organization's taxable year following the issuance of the Final Regulations.

Net Operating Losses

Coordination. The Final Regulations retain the general rule of the Proposed Regulations regarding coordination of losses arising in a taxable year beginning before January 1, 2018 ("pre-2018 NOLs"), which are not subject to the silo rule, and losses arising in a taxable year beginning after December 31, 2017 ("post-2017 NOLs"), which are subject to the rule. Pre-2018 NOLs are deducted against total UBTI before any post-2017 NOLs are deducted against the UBTI from the trades or businesses to which they are attributable. The Final Regulations clarify that pre-2018 NOLs are taken against total UBTI in a manner that allows for maximum utilization of post-2017 NOLs, but do not provide any specific methodology for making these allocations.

Termination of Unrelated Trade or Business. The Final Regulations provide that after offsetting any gain from the termination, sale, exchange or other disposition of a separate unrelated trade or business, any remaining NOLs from such trade or business are suspended. Such suspended NOLs may be used if the organization later resumes the previous separate unrelated trade or business or the organization commences a new unrelated trade or business that is classified by the same NAICS two-digit code as the unrelated trade or business in which the suspended NOLs arose.

Changing Identification of Unrelated Trade or Business. To address instances where a partnership interest that was a QPI becomes a non-QPI or where a NAICS two-digit code changes, the Final Regulations provide that a separate unrelated trade or business that changes identification is treated as if the original trade or business terminated and a new one commenced, with the result that NOLs from the original trade or business cannot be used against income from the newly identified trade or business and are suspended as if the organization had ceased the original trade or business. Similarly, if a QPI becomes a non-QPI, any NOLs attributable to the QPI are retained with the organization's investment activities and cannot be used against the former QPI's income following the change. An exception is provided for changes in NAICS two-digit codes that are attributable to correction of an accidental identification using the wrong code, or to a determination that a different code is more accurate. In this case NOLs attributable to the previously identified trade or business are treated as NOLs of the newly identified trade or business and can be used to offset income from such newly identified trade or business.

Reporting Considerations

While the Final Regulations make no changes to the regulations relating to partnership tax reporting, the preamble emphasizes that partnerships are required by statute to provide exempt organizations with all the information necessary to compute their distributive share of partnership income and loss in accordance with the UBTI rules, which the IRS and Treasury interpret to include any information needed in order to compute UBTI as a result of Section 512(a)(6). The preamble notes that the IRS may amend the partnership tax forms and instructions in the future to address the provision of such information.

The preamble also explains that the IRS is currently revising Form 990-T and that any trade or business not identified by the NAICS two-digit codes will be identified using non-NAICS codes that will be further explained in the final 2020 Form 990-T and instructions.

Effective Date

The Final Regulations are generally applicable with respect to taxable years beginning on or after December 2, 2020, though organizations may opt into certain favorable sections of the Final Regulations, including the provisions relating to NOL calculation and GILTI and Subpart F dividends, with respect to taxable years beginning on or after January 1, 2018.

For more information, please contact a member of the Tax-Exempt Organizations practice.