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Proposed Treasury Regulations Clarify UBTI "Silo" Rule

After undergoing a second review by the Office of Management and Budget, the IRS on April 24, 2020 published proposed Treasury Regulations addressing the unrelated business taxable income (UBTI) "silo" rules.

Tax-exempt organizations are subject to tax at rates applicable to corporations (or the rates applicable to trusts in certain cases) on UBTI, which is generally computed based on the organization's gross income from unrelated trades or businesses (generally, trades or businesses that are not substantially related to the organization's exempt purposes), net of expenses, losses, and other similar items directly connected to each such trade or business. Certain categories of investment-type income are excluded from UBTI, such as dividends, interest, rent, royalties, and gain or loss from certain property dispositions, unless such amounts are derived from controlled entities or debt-financed property.

Section 512(a)(6), enacted under the Tax Cuts and Jobs Act (TCJA) and commonly known as the UBTI "silo" rule, requires an exempt organization to calculate its UBTI separately for each unrelated trade or business carried on by it and prevents deductions from one unrelated trade or business from offsetting income from a different unrelated trade or business for tax years beginning after December 31, 2017. Notice 2018-67, issued in August 2018, provided interim guidance in applying the silo rule, and the proposed Treasury Regulations largely follow and partially expand that guidance.

General Silo Rule

Subject to a special rule for investment activities, exempt organizations are permitted to group their unrelated trades or businesses by the first two digits of their North American Industry Classification System (NAICS) codes. The NAICS has 20 separate sectors identified by two-digit codes. Notice 2018-67 proposed a safe harbor permitting exempt organizations to categorize their unrelated trades or businesses according to the more specific six-digit NAICS codes, of which there are over 1,000. As a result, the proposed Treasury Regulations permit more unrelated trades or businesses to be aggregated than had been contemplated under the Notice.

Once an exempt organization has assigned an NAICS two-digit code to an unrelated trade or business, it cannot change the assigned code unless it can show the initial code was chosen due to unintentional error and that a different code more accurately describes the trade or business.

Special Silo Rule for Investment Activities

In addition to the trades or businesses siloed under the general rule according to its two-digit NAICS code, the proposed Treasury Regulations permit three categories of "investment activities" to be aggregated and treated as a single, separate siloed unrelated trade or business: (1) qualifying partnership interests (QPIs); (2) debt-financed properties; and (3) qualifying S corporation interests.

QPIs

An exempt organization's interest in a partnership qualifies as a QPI if it meets either a de minimis or a control test. In applying either test, an exempt organization cannot have a QPI in a partnership in which it is a general partner.

A partnership interest meets the de minimis test if the exempt organization directly holds 2% or less of the profits and capital interests in the partnership.

A partnership interest meets the control test if the organization directly owns 20% or less of the capital interests and does not "control" the partnership. "Control" is based on all facts and circumstances, including the partnership agreement. However, the following circumstances represent per se control: (1) the organization itself has the power to 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 rights to participate in management or to conduct the partnership's business; or (3) the organization itself has the power to appoint or remove any of the partnership's officers or employees, or a majority of directors.

The Notice had included expansive aggregation rules requiring interests held by certain related parties of an exempt organization to be combined for purposes of applying the 2% and 20% thresholds under the de minimis and control tests. The proposed Treasury Regulations somewhat relax these rules, eliminating them entirely for the de minimis test and restricting them to require aggregation only from an organization's "supporting organizations" (as defined in Section 509(a)(3)) and "controlled entities" (as defined in Section 512(b)(13)(D)) for purposes of the control test.

The proposed Treasury Regulations also expand the Notice with a "look-through" rule that permits certain indirectly owned partnership interests to be treated as QPIs and aggregated with other investment activities, even if an exempt organization's direct interest in the upper-tier partnership does not qualify as a QPI. Under this rule, even if an exempt organization's direct interest in a partnership fails the control test and does not qualify as a QPI because the exempt organization owns more than 20% of the capital interests, as long as the exempt organization does not "control" the directly owned partnership, an exempt organization's indirect interest in a lower-tier partnership will qualify as a QPI if the exempt organization indirectly owns 2% or less of its profits and capital interests.

An organization can rely on a Schedule K-1 from a partnership to determine its percentage interests, but only to the extent the K-1 specifically lists the organization's profits or capital ownership interests at the beginning and end of the taxable year of the partnership (or the period of ownership within such year, if shorter). For this purpose, the percentage interest used to apply the 2% and 20% ownership thresholds is the average of the beginning and ending percentages derived from the K-1. However, the proposed Treasury Regulations are unclear on how an exempt organization must derive its percentage interests if it cannot rely on the information supplied to it on a partnership's K-1 (e.g., when the K-1 lists its percentage interests as "variable").

Similar to the Notice, the proposed Treasury Regulations include a transition rule permitting exempt organizations to aggregate as a separate unrelated trade or business all partnership interests acquired before August 21, 2018 that were not QPIs. However, the transition period ends on the first day of an organization's first taxable year beginning after final Treasury Regulations are published. An organization can rely on this transition rule even if its percentage interest in the partnership changes on or after August 21, 2018.

An exempt organization must designate a qualifying direct or indirect partnership interest as a QPI, and once designated, a QPI remains a QPI unless and until it no longer qualifies. This means that once an exempt organization identifies a qualifying partnership interest as a QPI, it must treat it as a separate investment activity and cannot reassign it under the general silo rules based on an applicable NAICS two-digit code (unless it fails to qualify as a QPI).

Debt-financed properties

An exempt organization is permitted to include as an investment activity all amounts treated as "unrelated debt-financed income" (UDFI) in connection with debt-financed property (not just UDFI from debt-financed property in connection with its QPIs, as the Notice had proposed). However, amounts that constitute UBTI without regard to the presence of debt financing are not attributed to investment activities and instead are grouped according to the applicable NAICS two-digit code under the general rule (examples include rent from property included as UBTI under Section 512(b)(3)(B) because more than 50% is attributable to personal property and rent from real property included as UBTI under Treasury Regulations Section 1.512(b)-1(c)(5) when services are also provided).

S corporations

An exempt organization's interest in an S corporation is treated as a separate unrelated trade or business, but any interest that meets the de minimis or control test may be treated as an investment activity and aggregated with the organization's other investment activities from QPIs and debt-financed properties. The exempt organization can rely on the Schedule K-1 received from the S corporation for purposes of determining its stock ownership percentage and applying the de minimis and control tests.

NOLs

The proposed Treasury Regulations helpfully clarify the ordering rules for pre- and post-TCJA net operating losses (NOLs). NOLs arising in tax years beginning on or before December 31, 2017 (pre-TCJA NOLs) are not subject to the UBTI silo rule. Therefore, pre-TCJA NOLs can offset any UBTI generated by an exempt organization. If an exempt organization has both pre-TCJA NOLs and post-TCJA NOLs (NOLs arising in tax years beginning after December 31, 2017), it must offset its pre-TCJA NOLs against UBTI first.

Notably, the proposed Treasury Regulations do not address the interaction of the UBTI silo rule with the revised NOL rules under the Coronavirus Aid, Relief, and Economic Security (CARES) Act for post-TCJA NOLs generated in taxable years beginning after December 31, 2017 and before January 1, 2021. For those years, NOLs can be carried back up to five years, and the 80% income limitation is temporarily repealed. The preamble indicates the IRS and Treasury will further consider the interaction between the silo rule and these changes under the CARES Act and may issue additional guidance.

"Controlled Entities"

Section 512(b)(13) generally treats certain amounts that would otherwise be exempt (any interest, annuity, royalty, or rent) as giving rise to UBTI when accrued or received from "controlled entities." The proposed Treasury Regulations do not permit these amounts to be treated as income from investment activities under the rules described above. Instead, all such amounts must be treated as attributable to an unrelated trade or business for each separate controlled entity.

Subpart F and GILTI

The proposed Treasury Regulations confirm that, for purposes of determining an exempt organization's UBTI, Subpart F and global intangible low-taxed income (GILTI) inclusions are treated in the same manner as dividends exempt under Section 512(b)(1), except for Subpart F insurance income, which is specifically includable as UBTI under Section 512(b)(17). Therefore, Subpart F income (other than insurance income) and GILTI are not subject to UBTI or the silo rules, unless they are separately includable as debt-financed income.

Any UBTI from insurance income under Section 512(b)(17) is treated as income from a separate unrelated trade or business, meaning that an exempt organization can combine such income received from multiple controlled foreign corporations, but cannot offset such income against any other category of UBTI.

Other Rules

The proposed Treasury Regulations also clarify that the silo rule does not apply for purposes of the public support tests applied under Sections 170(b)(1)(A)(vi) and 509(a)(1) and Section 509(a)(2). Additional rules apply to social clubs, voluntary employees' beneficiary associations, and supplemental unemployment compensation benefits trusts. The proposed Treasury Regulations incorporate existing rules for allocating deductions among related and unrelated trades or businesses, which generally require that allocations be done on a reasonable basis taking into account all facts and circumstances, but confirm that the unadjusted gross-to-gross method (which allocates expenses based on relative gross receipts) is not a reasonable method. The preamble notes that the IRS and Treasury continue to consider appropriate allocation rules and intend to publish a separate notice with further guidance on this issue.

Effective Dates

For taxable years beginning before the date that final Treasury Regulations are published, exempt organizations applying the silo rule may rely on the proposed Treasury Regulations or, alternatively, on the methods provided in the Notice or on a reasonable, good-faith interpretation of the rules governing UBTI, considering all facts and circumstances.

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