IRS Issues Final Regulations on UBTI "Silos"

By Marc Berger, CPA, JD, LLM, BDO USA

On December 2, 2020, the U.S. Treasury and IRS published final regulations under Internal Revenue Code (IRC or Code) Section 512(a)(6), the provision requiring tax-exempt organizations with more than one unrelated trade or business to calculate unrelated business taxable income (UBTI) separately with respect to each trade or business. The provision, which was added to the Code by the 2017 tax law often referred to as the Tax Cuts and Jobs Act (TCJA), is known as the UBI "Silo" provision. The final regulations provide guidance on how an exempt organization determines if it has more than one unrelated trade or business and, if so, how the organization calculates UBTI under Section 512(a)(6).

The final regulations generally follow the approach taken in the proposed regulations (issued in April 2020), while making a few modifications based on comments received from tax-exempt organizations and practitioners.

Identifying Separate Unrelated Trades or Businesses

Similar to the proposed regulations, most unrelated business activities must be classified using the first two digits of the North American Industry Classification System (NAICS) code that most accurately describes the trade or business. The IRS considered one commenter's view that the NAICS 2-digit codes be used as a safe harbor and that a facts and circumstances test be applied as the primary method of identifying separate unrelated trades or businesses. In rejecting that suggested change the IRS noted that adopting a facts and circumstances test would offer exempt organizations less certainty and likely result in inconsistency among exempt organizations conducting more than one unrelated trade or business because of differing approaches exempt organizations would take in applying such a test. It further stated that a facts and circumstances test would increase the administrative burden on the IRS which, upon examination, must perform the same fact-intensive analysis on each of the unrelated trades or businesses identified by the exempt organization.

In clarifying how an exempt organization should choose an NAICS 2-digit code, the IRS reiterated that the choice of the code must focus on the separate unrelated trade or business activity engaged in, and not the NAICS 2-digit code that describes the activities the conduct of which is substantially related to the exercise or performance of the organization's exempt purpose or function. For example, a college or university exempt under Section 501(c)(3) cannot use the NAICS 2-digit code for educational services to identify all of its separate unrelated trades or businesses.

One area in which the final regulations differed from the proposed regulations concerns the ability to change an NAICS 2-digit code once it has been selected and reported on Form 990-T. The proposed regulations generally provided that, once an organization has identified a separate unrelated trade or business using a particular NAICS 2-digit code, the organization cannot change the NAICS 2-digit code describing that separate unrelated trade or business unless two requirements are met. First, the exempt organization must show that the NAICS 2-digit code chosen was due to an unintentional error. Second, the exempt organization must show that another NAICS 2-digit code more accurately describes the unrelated trade or business. In response to numerous comments on this issue, the final regulations remove the restriction requirements for changing NAICS 2-digit code(s). Instead, the final regulations require an exempt

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organization that changes the identification of a separate unrelated trade or business to report the change in the taxable year of the change in accordance with forms and instructions. To report the change, the final regulations require an organization to provide certain information with respect to each separate unrelated trade or business the identification of which changes: (1) the identification of the separate unrelated trade or business in the previous taxable year, (2) the identification of the separate unrelated trade or business in the current taxable year, and (3) the reason for the change. The IRS anticipates that the instructions to the Form 990-T will be revised to provide instructions regarding where and how changes in identification are reported.

Activities Deemed Separate Trades or Businesses

As provided under the proposed regulations, certain activities are treated as separate trades or businesses under the final regulations.

Investment Activities

The proposed regulations provided an exclusive list of an exempt organization's investment activities that may be treated as a separate unrelated trade or business for purposes of section 512(a)(6). Under the proposed regulations, for most exempt organizations, such investment activities are limited to: (i) qualifying partnership interests; (ii) qualifying S corporation interests; and (iii) debt-financed properties. Although commenters recommended modifications to the rules regarding the individual items included in this list, no commenters objected to the treatment of these items as investment activities. The final regulations adopt this list of investment activities without change.

Similar to the proposed regulations, the final regulations permit the aggregation of qualifying partnership interests (QPIs) into one separate unrelated trade or business in order to reduce the administrative burden of obtaining information from the partnership regarding its underlying trade or business activities where its percentage interest level indicates that the exempt organization does not significantly participate in the partnership. QPIs are generally defined as partnership interests that meet one of two tests: (1) **A de minimis test**, which the exempt organization satisfies if it holds directly or indirectly no more than 2% of the profits interest and no more than 2% of the capital interest of the partnership; or (2) **A participation test** (formerly known as the "control test" under the proposed regulations), which the exempt organization satisfies if it holds directly or indirectly no more than 20% of the capital interest and does not "significantly participate in" (formerly "control") the partnership.

As modified by the final regulations, an exempt organization significantly participates in a partnership if:

- The exempt organization, by itself, may require the partnership to perform, or prevent the partnership from performing (other than through a unanimous voting requirement or through minority consent rights), any act that significantly affects the operations of the partnership;
- Any of the exempt 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 directors.

Similar to the proposed regulations, the final regulations require the interests of certain supporting organizations and controlled entities to be combined with those of the exempt organization in determining whether the organization's interest crosses the participation test's 20% threshold. One difference, however, is that the final regulations do not require an organization to combine the interests of a Type III supporting organization unless that supporting organization is the organization's parent.

In making the determination whether an exempt organization's interest in a partnership meets one of the two tests to be a QPI, the final regulations follow the rule in the proposed regulations that an exempt organization's percentage interest is determined by averaging the organization's percentage interest at the beginning of the partnership's tax year with its percentage interest at the end of that same partnership tax year. The final regulations, however, now provide a grace period when a change in an organization's percentage interest is due entirely to the actions of other partners. The grace period permits a partnership interest that fails to meet the requirements of either test because of an increase in the current year's percentage interest may be treated as meeting the requirements of the de minimis test or the participation test that it met in the prior year for the taxable year of the change if: (1) the partnership interest met the requirements of the de minimis test or the participation test in the organization's prior taxable year without application of the grace period; (2) the increase in percentage interest is due to the actions of one or more partners other than the exempt organization; and (3) in the case where a partnership interest met the participation test in the prior taxable year, the interest of the partner or partners that caused the increase in the current year was not one that was combined with the exempt organization's interest as described in the preceding paragraph in either the prior or current year.

With respect to qualifying S corporation interests (QSIs), the final regulations clarify that the exempt organization can rely on the Schedule K-1 (Form 1120-S) that it received from the S corporation if the form lists information sufficient to determine the organization's percentage of stock ownership for the year. For example, a Schedule K-1 that reports "zero" as the organization's percentage interest in the S corporation is not sufficient to determine the organization's percentage of stock ownership for the year. The IRS is considering whether revision of Schedule K-1 is needed to provide the information necessary to determine whether an S corporation interest is a QSI.

With respect to debt-financed income, several commenters suggested that this income should be reportable using an NAICS 2-digit code instead of as an investment activity. The final regulations rejected this suggestion and adopted the proposed regulations treatment as a separate investment activity.

Finally, the transition rule included in both IRS 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 final regulations. Despite receiving several comments asking the Treasury Department and the IRS to adopt the transition rule as a grandfather rule, it was not so adopted in the final regulations.

Payments from Controlled Entities

Similar to the proposed regulations, all "specified payments" (i.e., interest, rents, royalties, and annuity payments per Code Sec. 512(b)(13)) received by a controlling tax-exempt organization from an entity it controls (i.e., more than 50 percent controlled by the organization) are treated as gross income from a separate unrelated trade or business. Moreover, if a controlling organization receives specified payments from two different controlled entities, the payments from each controlled entity would be treated as a separate unrelated trade or business.

The final regulations are applicable to tax years beginning on or after December 2, 2020. For virtually all exempt organizations this means their 2021 tax years.

Certain Amounts from Controlled Foreign Corporations (CFCs)

Similar to the proposed regulations, amounts included in UBTI under Section 512(b)(17) are treated as income derived from a single separate unrelated trade or business.

Other Items of Note

Allocation of Expenses – Pending the publication of further guidance in a separate notice of proposed rulemaking, the final regulations continue to provide that an exempt organization with more than one unrelated trade or business must allocate deductions between separate unrelated trades or businesses using the reasonable basis standard described in Treas. Reg. Section 1.512(a)-1(c).

Net Operating Losses (NOLs) – Under Section 512(a)(6), NOLs arising in a tax year beginning before January 1, 2018 ("pre-2018 NOLs") may be taken against aggregate or total UBTI, while NOLs arising in a tax year beginning after December 31, 2017 ("post-2017 NOLs") may only be taken against UBTI from the same trade or business from which the post-2017 NOL arose. The final regulations require an organization with both pre-2018 NOLs and post-2017 NOLs to first deduct its pre-2018 NOLs from its total UBTI before deducting any post-2017 NOLs from the UBTI of the separate trade or business that gave rise to the NOL. The final regulations further provide that if a trade or business is terminated, sold, exchanged, or disposed of, any NOLs remaining after offsetting any gain on the sale or disposition are suspended. Suspended NOLs may only be used if the previous business is later resumed or if a new business using the same NAICS 2-digit code is commenced or acquired. For this purpose, a business is considered "terminated" if the appropriate identification of the business changes from one NAICS code to a different NAICS code.

Charitable Contributions – Under Section 512(b)(10), tax-exempt corporations can take charitable contribution deductions under Section 170 up to 10% of UBTI (tax-exempt trusts look to Section 512(b)(11) for its percentage limitations). The final regulations provide that in applying these percentage limitations, exempt organizations would use total UBTI computed pursuant to Section 512(a)(6) and would not allocate the charitable contribution deduction among silos.

Public Support Tests – The final regulations address the fact that the calculation of public support on Form 990, Schedule A could be negatively impacted by the treatment of UBTI under the new silo rules. To address this issue, the final regulations allow exempt organizations to calculate public support tests using either UBTI as computed under Section 512(a)(6) or UBI calculated in the aggregate, whichever is least administratively burdensome or provides the highest ratio for the organization.

Subpart F and Global Intangible Low-Taxed Income – Similar to the proposed regulations, the final regulations clarify that inclusions of Subpart F income under Section 951(a)(1)(A) and global intangible low-taxed income (GILTI) under Section 951A(a) are treated in the same manner as dividends for purposes of Section 512(b)(1).

The final regulations are applicable to tax years beginning on or after December 2, 2020 (date of publication in the Federal Register). For virtually all exempt organizations this means their 2021 tax years. Organizations should consult with their tax advisors to ensure the identification of any and all of their separate unrelated trades or businesses, especially those organizations with significant investment activities.

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