SULLIVAN & CROMWELL LLP

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IRS Releases Initial Guidance on the Internal Revenue Code's "UBTI Silo" Rule

Notice 2018-67 Establishes Interim and Transition Rules for Tax-Exempt Organizations Calculating Unrelated Business Taxable Income ("UBTI") With Respect to Partnership Investments.

SUMMARY

The Internal Revenue Service (the "IRS") recently released Notice 2018-67 (the "Notice"), providing initial guidance for tax-exempt organizations calculating unrelated business taxable income ("UBTI") under changes made to the Internal Revenue Code (the "Code") as part of the Tax Cuts and Jobs Act of 2017 (the "Act").

In particular, the Notice relaxes the newly enacted "UBTI silo rule", which requires tax-exempt organizations to compute UBTI separately for each unrelated trade or business. Pending release of proposed regulations that would treat certain investment activities of a tax-exempt organization as one trade or business for the purposes of the UBTI silo rule, the Notice creates two rules that allow a tax-exempt organization to aggregate UBTI with respect to "qualifying partnership interests", as well as UBTI with respect to partnership interests acquired before August 21, 2018. The Notice also offers other guidance to tax-exempt organizations calculating UBTI under changes made to the Code under the Act.

BACKGROUND

Organizations that are generally exempt from U.S. federal income tax are subject to tax on income from an unrelated trade or business. Generally, an unrelated trade or business is any trade or business regularly carried on by the tax-exempt organization that is not substantially related to the performance of the organization's tax-exempt function. Certain types of income are specifically exempt from UBTI, such

as dividends, interest, royalties, and certain rents, unless such income is derived from debt-financed property.

A tax-exempt organization may engage in more than one unrelated trade or business, and may carry on an unrelated trade or business indirectly through another entity, such as a partnership. If a partnership regularly carries on a trade or business that is "unrelated" with respect to the tax-exempt organization, a tax-exempt organization would include in UBTI its distributive share of partnership gross income (whether or not distributed) and partnership deductions directly connected with such gross income, subject to certain modifications.

The UBTI Silo Rule

In determining UBTI prior to the Act, a tax-exempt organization engaged in multiple unrelated trades or businesses would aggregate income and deductions from all such activities. As a result, an organization could use losses from one unrelated trade or business to offset income from another, thereby reducing total UBTI.

Under the Act's UBTI silo rule, a tax-exempt organization with more than one unrelated trade or business must compute UBTI separately with respect to each unrelated trade or business (*i.e.*, tax-exempt organizations are no longer allowed to aggregate income and deductions from multiple unrelated trades or businesses).

For a tax-exempt organization that is a partner in a partnership, one interpretation of the UBTI silo rule might require the tax-exempt organization to calculate UBTI separately with respect to each unrelated trade or business regularly carried on by the partnership in which the tax-exempt organization is a direct or indirect partner. For example, if a tax-exempt organization is a partner in a holding partnership that is a partner in multiple lower-tier partnerships, many of which engage in one or more unrelated trades or businesses with respect to the tax-exempt organization partner, the tax-exempt organization might have been treated as engaged in multiple separate unrelated trades or businesses through its interest in the partnership, all of which would be subject to the UBTI silo rule.

GUIDANCE

Aggregating Investment Activities

In Notice 2018-67, the IRS announced its intention to propose regulations treating certain investment activities of a tax-exempt organization as one trade or business for the purposes of the UBTI silo rule in order to permit tax-exempt organizations to aggregate gross income and directly connected deductions from such investment activities. The Notice cites the administrative burden of reporting UBTI from interests in multi-tier partnerships and the difficulty of obtaining sufficient information regarding the trade or business activities of lower-tier partnerships as reasons for permitting aggregation in the case of such investments.

For tax-exempt organizations invested in partnerships (such as private equity funds, hedge funds, or other alternative asset vehicles, generally), the Notice also provides that tax-exempt organizations may aggregate UBTI from such investments under the Interim Rule or Transition Rule, each defined below, pending publication of proposed regulations.

The Interim Rule. Under the Interim Rule, tax-exempt organizations may aggregate UBTI from an investment in a single partnership with multiple trades or businesses (including those conducted by lower-tier partnerships) if the directly held interest in the partnership is a "qualifying partnership interest" under either (i) the *de minimis* test, or (ii) the control test (the "Interim Rule"). Furthermore, an exempt organization may aggregate all qualifying partnership interests and treat the aggregate group of qualifying partnership interests as a single trade or business.

1. The *De Minimis* Test. A partnership interest is a qualifying partnership interest under the *de minimis* test if the tax-exempt organization directly holds no more than (i) two percent of the profits interest, and (ii) two percent of the capital interest, subject to the rules for combining related interests discussed below. In determining the tax-exempt organization's percentage interest in a partnership, the tax-exempt organization may rely on the Schedule K-1 it receives from the partnership. To the extent that a specific profits interest is not identified in Part II, Line J, of Schedule K-1, a tax-exempt organization does not meet the *de minimis* test.
2. The Control Test. A partnership interest is a qualifying partnership interest under the control test if the tax-exempt organization (i) directly holds no more than 20 percent of the capital interest, and (ii) does not have control or influence over the partnership, subject to the rules for combining related interests discussed below. All facts and circumstances are relevant for determining whether a tax-exempt organization has control or influence over a partnership. For example, the Notice provides that a tax-exempt organization has control or influence over a partnership if the tax-exempt organization may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership; if any of the tax-exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time; or if the tax-exempt organization has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees.

As a result of the Interim Rule, tax-exempt organizations that would otherwise prefer investing through single "side car" or "managed account" structures may prefer investing through partnerships in which the tax-exempt organization has 20 percent or less of the capital and over which the tax-exempt organization does not have "control or influence".

Combining Related Interests. For purposes of the *de minimis* test and the control test, a tax-exempt organization's percentage interest in a partnership also includes the partnership interests owned by any "supporting organization", "disqualified person", or "controlled entity", as defined below, with respect to the organization.

1. Supporting Organization. A supporting organization is generally a charity that carries out its exempt purpose by supporting the tax-exempt organization.

2. Disqualified Person. Disqualified persons include, generally:

- any person in a position to exercise substantial influence over the affairs of the tax-exempt organization at any time in the preceding five years (a "control person"), or a family member of such control person (together with any control persons, "associated persons");
- any "35-percent controlled entity", defined as any corporation in which associated persons own more than 35 percent of the total combined voting power, any partnership in which associated persons own more than 35 percent of the profits, or any trust or estate in which associated persons own more than 35 percent of the beneficial interest;
- any associated person or 35-percent controlled entity with respect to a supporting organization of the tax-exempt organization; and
- with respect to a donor advised fund, any advising donor or appointed donor advisor (each, a "DAF advisor"), any family member of a DAF advisor (a "DAF advisor relation"), or any "35-percent DAF advisor controlled entity", defined as a 35-percent controlled entity, substituting DAF advisor and DAF advisor relation for associated persons.

3. Controlled Entity. A controlled entity is defined as:

- any corporation in which the tax-exempt organization owns more than 50 percent by vote or value;
- any partnership for which the tax-exempt organization owns more than 50 percent of the profits interests or capital interests; and
- any entity (other than a corporation or partnership) for which the tax-exempt organization owns more than 50 percent of the beneficial interests.

  Constructive ownership rules apply in calculating percentage ownership of a controlled entity.

The Transition Rule. Pending publication of proposed regulations, a tax-exempt organization may treat a partnership interest acquired before August 21, 2018 as a single trade or business under the Transition Rule, whether or not such partnership (or any lower-tier partnership) directly or indirectly conducts more than one trade or business. An exempt organization may follow the Transition Rule for partnership interests with respect to which it is not applying the Interim Rule. Note, however, that a tax-exempt organization may not aggregate all partnership interests qualifying under the Transition Rule to treat the aggregate group of partnership interests as a single trade or business.[1]

The income permitted to be aggregated under the Interim Rule and Transition Rule includes any unrelated debt-financed income arising in connection with the partnership interest satisfying the Interim Rule or Transition Rule.

[1] In contrast, the Interim Rule allows an exempt organization to aggregate all qualifying partnership interests and treat the aggregate group of qualifying partnership interests as a single trade or business.

Determining a Separate Unrelated Trade or Business

The Act does not provide criteria for determining whether a tax-exempt organization has more than one unrelated trade or business, or how to identify separate unrelated trades or businesses for purposes of calculating UBTI under the UBTI silo rule. Pending release of proposed regulations, the Notice provides that tax-exempt organizations may rely on a reasonable, good-faith interpretation of specific Code sections defining unrelated trade or business income, considering all facts and circumstances, in determining whether an organization has more than one unrelated trade or business for purposes of the UBTI silo rule. Such a reasonable, good-faith interpretation includes use of the North American Industry Classification System (NAICS) codes to identify separate trades or businesses. For other guidance in determining separate unrelated trades or businesses, the Treasury and IRS suggest that tax-exempt organizations consider the "fragmentation principle", which provides that an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of an organization.

Effective Date and Request for Comment

For taxable years beginning after December 31, 2017, tax-exempt organizations may rely on the Interim Rule and Transition Rule for aggregating income from partnerships and the methods of aggregating or identifying separate trades or businesses provided in the Notice, until proposed regulations are published. Until regulations are proposed, tax-exempt organizations may also rely on the use of NAICS codes as a reasonable, good-faith interpretation of the Code when determining whether an organization has more than one unrelated trade or business. Tax-exempt organizations may also rely on the rule generally excluding GILTI from UBTI.

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