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IRS Proposes Rules on UBIT Changes Affecting Benefit Plan Investors

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A pension or welfare plan's investment in a private equity or real estate partnership, among other investment funds, may give rise to "unrelated business income tax" ("UBIT"). In recent years, this issue has arisen frequently as more plans have invested in such vehicles. The Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act") made important changes in this area, creating the potential for greater UBIT liabilities for plan investors. IRS Notice 2018-67 (the "Notice"), issued in August 2018, provided helpful guidance that mitigated the impact of these changes for plan investors pending the development of proposed regulations. Treasury and IRS recently published proposed regulations (the "Proposed UBIT Regulations") which build upon the guidance in the **Notice. 85 Fed. Reg. 23172** (Apr. 24, 2020). We summarize the Proposed UBIT Regulations below.

A. Background

Under the UBIT rules, tax-qualified retirement plans, voluntary employees' beneficiary associations ("VEBAs"), and individual retirement accounts ("IRAs") may have UBIT merely by investing in a limited partnership that borrows to make one or more investments. Under Code section 514, ownership of such "debt-financed property" generally causes a proportionate share of the income from that investment to be subject to UBIT. A longstanding (though complex) provision – the "fractions rule" – exempts most debt-financed real estate investments from UBIT for pension plans (though not for VEBAs). IRC § 514(c)(9). Plans have often used foreign "blocker" corporations to shelter other income from UBIT, although the costs and benefits of that approach need to be examined on a case-by-case basis. And even if no debt is used, if a limited partnership invests in an active trade or business (e.g., directly operates a hotel or participates in an operating company), the plan investor's income will be subject to UBIT. IRC § 512(c).

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Historically, the calculation of UBIT has allowed plan investors to claim their share of associated expenses against income – and to net most gains and losses – for their trades or businesses in the aggregate, just like any taxpayer. IRC § 512(a)(1). In the case of a trust, the net income is subject to the individual tax rates – as high as 37% in 2020 – and reported on IRS Form 990-T. IRC § 511(b). State taxes and filings also may apply.

B. What the 2017 Tax Act Changed

Effective for tax years beginning after December 31, 2017, benefit plans with two or more unrelated trades or businesses are no longer be able to "net" the income and losses of those trades or businesses in the aggregate when determining their UBIT. Instead, the plan's UBIT for the tax year is based on the sum of the unrelated business income ("UBI") (but not less than $0) for each separate trade or business. IRC § 512(a)(6). The 2017 Tax Act also limited the application of the carryover of net operating losses for tax years beginning after December 31, 2017 to the UBI of the same trade or business in future years. However, net operating losses from tax years beginning prior to 2018 can still be applied to any trade or business to reduce the amount of UBI subject to UBIT.

C. Key Guidance for Benefit Plan Investors

A significant uncertainty in this area has been whether each investment held by a plan is a separate "trade or business" (such that a plan must calculate its UBIT for each individual investment) or whether a plan can consider all investments of the same "type" (e.g., all real estate investments or all private equity funds) as a single trade or business (such that a plan can calculate its UBIT across all of these investments in the aggregate, netting gains and losses on the whole). The Notice provided a variety of approaches that plans may apply to simplify the impact of this change. The Proposed UBIT Regulations retain many of the concepts included in the Notice but with some significant modifications.

1. Reliance on NAICS Codes – Like the Notice, the Proposed UBIT Regulations state that (before final rules are published) exempt organizations "may rely on a reasonable good faith interpretation" of the UBIT rules, considering all the facts and circumstances, when determining whether the organization has more than one trade or business under the new law. This principle recognizes that the concept of a "separate trade or business" is not defined and may even vary under different Code sections.

The Notice provided a safe harbor under which a six-digit code described in section 3.03 of the North American Industry Classification System ("NAICS") may be considered a "trade or business" separate from an activity in another six-digit code. In response to comments, the IRS modified its approach in the Proposed UBIT Regulations to provide for use of only the first two digits of the NAICS codes – a much broader description – as identifying a separate trade or business. The two-digit codes generally cover 20 different industries or business sectors and are viewed as easier to administer. For plans, however, the provisions of the Proposed UBIT Regulations that focus on "investment activities," summarized below, usually will govern UBIT calculations.

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2. Aggregation of Investment Activities – A number of commenters suggested that *all* of an exempt organization's investment activities should be treated as a single separate trade or business. The policy underlying this approach is that passive investment activities should not have to be classified based on the nature of the underlying investment activity (*e.g.*, real estate, oil and gas ventures, etc.), but rather should be treated simply as the business of investing. This is the case even though a partnership investment is treated as an unrelated trade or business for UBIT purposes under Code section 512(c) (whether the partner is active or passive).

Accordingly, the Proposed UBIT Regulations provide an exclusive list of investment activities that can be treated as one separate unrelated trade or business for purposes of Code section 512(a)(6). This concept of "investment activities" includes the following:

- qualifying partnership interests or "QPI" (see subpart a below),
- debt-financed properties (see subpart b. below), and
- qualifying S corporation interests.

In effect, all of the gains and losses from all of these investments in the aggregate can be netted for UBIT purposes, thereby generally permitting plan investors to calculate UBIT from these investments as they did prior to the UBIT changes enacted in the 2017 Tax Act.

- **a) "Qualifying Partnership Interests"** – This concept combines two approaches described in the Notice into a single category.
  - ***"De Minimis" Test*** – Under this rule, an exempt organization may treat a partnership interest as a QPI if the exempt organization directly holds no more than two percent of the profits interest and no more than two percent of the capital interest in the partnership. The Schedule K-1 (which each partnership investor is required to receive) may be relied on in applying the two percent threshold. While the Notice required aggregating the interests of a disqualified person or controlled entity for this purpose, the Proposed UBIT Regulations generally do not require that under this test.
  - ***"Control" Test*** – Under the "control" test, if the exempt organization directly holds no more than 20 percent of the capital interest in a partnership (again based on the Schedule K-1), and does not have "control" over partnership activities based on the facts and circumstances, the partnership interest is a QPI. Thus, the plan may combine the results of such a holding with its other "qualifying partnership interests" in applying the new rules. The Proposed UBIT Regulations provide that "all facts and circumstances, including the partnership agreement, are relevant for determining whether an organization controls a partnership." The Proposed UBIT Regulations

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then list four rights or powers that the organization and various associated persons may have that will constitute "control" (including by itself requiring the partnership to perform or preventing the partnership from performing acts that significantly affect the partnership's operations; participation in partnership management; conducting partnership business; and by itself appointing partnership officers, employees, or directors). Prop. Reg. 1.512(a)-6(c)(4)(iii).

- **b) Debt-Financed Propertie**s – Longstanding rules under Code section 514 generally treat income from an investment as UBI if there is "acquisition indebtedness" associated with that investment. The UBI is based on the level of debt financing, *i.e.*, if 40% of the property is debt-financed, then 40% of the net income from the property is UBI.
- Under the Proposed UBIT Regulations, if a plan has separate debt-financed investments, *i.e.*, not associated with its partnership holdings, it should combine that debt-financed income with income from its qualifying partnership interests for calculating UBIT.

D. Application to VEBAs

In general, the calculation of the UBIT of a VEBA (described in Code section 501(c)(9)) for its investment activities will be the same as the calculation of UBIT for a qualified plan or IRA, described above. In addition, the Proposed UBIT Regulations recognize that (except for collectively bargained VEBAs and those maintained by tax-exempt organizations) a VEBA is subject to tax on amounts held in excess of the complex Code section 419/419A account limits at the end of its tax year.

The Proposed UBTI Regulations take a somewhat circular approach to the calculations providing initially for the inclusion of passive categories of investment income described in Code section 512(b)(1)-(3) and (5), and then for its exclusion as long as such income is to be used for the payment of permissible VEBA benefits. See Prop. Reg. § 1.512(a)-6(c)(6). We interpret this approach to mean that a VEBA with "excess" reserves may need to apply the new rules in the same manner that a qualified plan or IRA would. IRS and Treasury request comments in this area.

E. Effective Dates/Compliance Options

As proposed, plan investors will not be required to comply with final rules for taxable years that began before they are published in the *Federal Register*. In the meantime, plans and IRAs have several options available for calculating UBIT –

1. Plans may rely on a "reasonable good faith interpretation" of the UBIT rules (secs. 511-14) considering all the facts and circumstances to identify separate unrelated trades or business.
2. Plans may rely on the methods of aggregating and identifying separate trades or businesses under the guidance in the Notice.
3. Plans may rely on the Proposed UBIT Regulations "in their entirety."

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In addition, recognizing that it may be difficult to make the *de minimis* and "control" determinations, the Proposed UBIT Regulations (like the Notice) generally allow each existing partnership interest as of August 21, 2018 to be treated as a single trade or business – even where one or more such partnerships indirectly hold multiple lower-tier partnerships (e.g., a "fund of funds" investment arrangement). Thus, regardless of the level of an organization's ownership, the partnership interest will be treated as a qualifying partnership interest, but only before final IRS regulations are published. This grandfather rule applies during the transition period even if the organization increases its percentage ownership interest after August 18, 2018.

For qualified plans and IRAs, general reliance on the Proposed UBIT Regulations appears to be advisable since they provide the most comprehensive guidance, and generally carry forward the key operating rules – the "de minimis test," the "control test," and the "grandfather rule" from the Notice.

IRS has requested comments on the proposed rules by June 23. Plans should be reviewing all of their investment holdings in light of the Proposed UBIT Regulations to identify possible problem areas and comments to submit.

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