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Final UBIT Regulations Likely to Affect Many Benefit Plan Investors

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A pension or welfare plan's investment in a private equity fund, hedge fund, 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 and Treasury recently released final regulations implementing the 2017 Tax Act changes regarding how UBIT is calculated. 85 Fed. Reg. 77952 (Dec. 2, 2020) (the "Final Regulations"). The Final Regulations apply to taxable years beginning on or after December 2, 2020. For prior years beginning on or after January 1, 2018, exempt organizations may rely on the Final Regulations or can apply reasonable good faith interpretations of Section 512(a)(6) of the Internal Revenue Code (the "Code"), including methods for identifying separate trades or businesses in Notice 2018-67 (the "Notice") or the April 2020 proposed UBIT regulations (the "Proposed UBIT Regulations"), in lieu of the Final Regulations.

We summarize the key aspects of the Final Regulations below.

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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 complex longstanding provision – the "fractions rule" – exempts most debt-financed real estate investments from UBIT for qualified plans (though not for IRAs or 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).

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, a benefit plan with two or more unrelated trades or businesses is no longer able to "net" the income and losses of those trades or businesses in the aggregate when determining 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.

A significant area of uncertainty 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 soften the impact of this change under the 2017 Tax Act. The Proposed Regulations retained many of the concepts included in the Notice, but with some significant modifications. While the Notice and Proposed Regulations provided some helpful approaches to simplify the new rules for benefit plan investors, the IRS resisted making additional changes along these lines in the Final Regulations. For example, the IRS did not increase the thresholds for "qualifying partnership interests" described in the Proposed Regulations and rejected the request of some commenters to grandfather partnership interests held before August 21, 2018. Similarly, the IRS declined to allow aggregation of <u>all</u> investment activities by benefit plans, regardless of the ERISA policy considerations cited by commenters.

Nevertheless, the Final Regulations did make some important changes to the Proposed Regulations, summarized below.

C. Key Guidance for Benefit Plan Investors

Reliance on Two-Digit NAICS Codes – The concept of a "separate trade or business" is not defined in the tax law 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 (the "NAICS") may be considered a "trade or business" separate from an activity in another six-digit code. The IRS modified its approach in the Proposed Regulations to provide for use of only the first two digits of the NAICS codes – a much broader description – to identify a separate trade or business. The two-digit codes generally cover 20 different industries or business sectors and are viewed as easier to administer. The Final Regulations generally retain this two-digit approach, and generally reject other approaches to identify separate trades or businesses (including a "facts and circumstances" test). As explained below, however, the separate provisions of the Final Regulations that focus on "investment activities" usually will govern UBIT calculations for benefit plan investors.

Aggregation of Most 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 argument underlying this approach is that passive investment activities should not be classified based on the nature of the underlying investment activity (*e.g.*, real estate, timber, oil and gas ventures, etc.), but rather should be treated simply as the business of investing. While the IRS was unwilling to go that far, the Final Regulations provide an exclusive list of investment activities that can be treated as one separate unrelated trade or business for purposes of UBIT calculations under Code section 512(a)(6). This exclusive list of "investment activities" includes the following:

- qualifying partnership interests or "QPIs",
- debt-financed properties, 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.

Helpfully, under the approach reflected in the Final Regulations, benefit plan trusts and IRAs should only be prevented from netting gains and losses for those investments that are <u>not</u> QPIs (including debt-financed properties for this purpose). Non-qualifying interests would include any property individually owned by the trust/IRA, and any general partnership interest.

1. *"Qualifying Partnership Interests"*

- **"De Minimis" Test** – Under this test, 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.
- **"Participation" Test** – Under the "participation" 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 significantly participate in partnership activities, the partnership interest is a QPI. The Final Regulations clarify that, with respect to the participation test, an exempt organization must meet the 20 percent or less percentage requirement for the exempt

organization's taxable year with which or in which the partnership's taxable year ends. For purposes of both the de minimis test and the participation test, an exempt organization determines its percentage interest by taking the average of the exempt organization's percentage interest at the beginning and end of the partnership's taxable year or, in the case of a partnership interest held for less than a year, the percentage interest held at the beginning and end of the ownership period within the partnership's taxable year. In a helpful change, the Final Regulations drop the "facts and circumstances" component of the participation test previously included in the Proposed Regulations in favor of an exclusive list of four factors that evidence an exempt organization's per se "significant participation" in a partnership. Also helpful to exempt organizations is the fact that the four factors are modified from the Proposed Regulations to permit an exempt organization to participate in matters requiring a unanimous vote by the partnership's partners or to exercise minority consent rights, in each case without constituting "significant participation" in the partnership. As modified, the four factors are:

- 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 exempt organization's officers, directors, trustees, or employees have rights to conduct the partnership's business at any time; or
- the exempt organization, *by itself*, has the power to appoint or remove any of the partnership's officers or employees or a majority of directors.

The IRS confirms in the Final Regulations that an exempt organization need not consider rights or powers *other than* the above four factors when determining whether a partnership is a QPI for purposes of the participation test.

2. *"Look-Through" Rule for QPIs*

The Proposed Regulations included a "look-through" rule for QPIs, which provided that if an exempt organization holds more than 20 percent of the capital interest of a partnership but *does not* control that partnership, any partnership in which the exempt organization holds an *indirect* interest through the directly-held partnership interest may be a QPI if the indirectly-held partnership interest meets the de minimis test. Notably, the Final Regulations expand this look-through rule in a couple of ways that are helpful to exempt organizations:

- First, the Final Regulations do not prevent application of the look-through rule if the exempt organization significantly participates in the directly-held partnership.
- Second, the Final Regulations clarify that an indirectly-held partnership interest that satisfies the participation test with regard to the immediately higher-tier partnership that owns an

interest in that partnership also may be a qualifying partnership interest of the exempt organization.

The impact of the above two clarifications is that the participation test will apply tier-by-tier to the exempt organization's indirectly-held partnership interests, thereby potentially broadening the relief available to exempt organizations under the participation test.

3. *"Special Grace Period" Rule*

The Final Regulations adopt a grace period for an exempt organization that fails to satisfy the de minimis test or the participation test due entirely to the actions of other partners in a partnership. Specifically, an exempt organization's partnership interest that fails to meet the requirements of either the de minimis test or the participation test because of an increase in percentage interest during that exempt organization's taxable year may still be treated as meeting the requirements of the test that the exempt organization satisfied in its prior taxable year, if:

- The partnership interest satisfied the requirements of the de minimis test or participation test, respectively, in the exempt organization's prior taxable year *without* application of the grace period;
- The increase in percentage interest is due to the actions of one or more partners *other than* the exempt organization;
- The interest of the partner(s) that caused the increase in percentage interest was and is not combined with the interest of the exempt organization; and
- The exempt organization reduces its percentage interest before the end of the next taxable year to satisfy the de minimis test or the participation test.

Debt-Financed Properties – 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 Final 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 QPIs for calculating UBIT.

Some Important Calculation Rules

Exempt organizations with more than one unrelated trade or business must allocate deductions between separate trades or businesses using the "reasonable basis" standard described in Treas. Reg. § 1.512(a)-1(c).

The Final Regulations clarify that the total UBTI of an exempt organization with more than one unrelated trade or business is the sum of the UBTI with respect to *each* separate unrelated trade or business, less (i) a charitable contribution deduction, (ii) an NOL deduction for losses arising during taxable years beginning before January 1, 2018, and (iii) a specific deduction under Section 512(b)(12) of the Code, as applicable. The Final Regulations clarify that all *other* deductions must be taken against the UBTI of *each* separate unrelated trade or business.

The Final Regulations clarify that pre-2018 NOLs must be taken against total UBTI in a manner that allows for maximum utilization of post-2017 NOLs, rather than pre-2018 NOLs, in a taxable year.

Application to VEBAs

The Final Regulations provide that a VEBA determines whether it has more than one unrelated trade or business in the same manner as a pension plan subject to Section 512(a)(1) of the Code. The Final Regulations also note (as did the Proposed Regulations) that although VEBAs must include interest, annuities, dividends, royalties, rents, and capital gains in their initial UBTI determination, such amounts may be excluded from UBTI if set aside (and not in excess of the set aside limit applicable to VEBAs under the Code) and used for a purpose described in Section 512(a)(3)(B)(i) or (ii) of the Code. The preamble to the Final Regulations states that no comments were received as to the impact on VEBAs. Thus, no changes were made from the Proposed Regulations.

Expected Changes in Form 990-T

The IRS is revising the 2020 Form 990-T and its related instructions. As part of that revision, the IRS expects to identify separate unrelated trades or business that are *not* identified using NAICS 2-digit codes (e.g., investment activities) with numeric codes that are distinguishable from NAICS codes.

For 2020 tax years, the new Schedule A will reflect separate reporting of each trade or business. Filers will use a separate Schedule A for each trade or business and then calculate the tax on Form 990-T.

The IRS expects e-filing will be required as early as February, though specific dates are to be announced.

Effective Dates/Compliance Options

Plan investors are not required to comply with the Final Regulations for taxable years that began before December 2, 2020. For prior years (2018-2020), 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 – as well as the guidance for identifying and combining interests allowed under the Notice or the Proposed Regulations. In addition, for such prior years, each existing partnership interest as of August 21, 2018 may 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 QPI, but only in tax years before the Final Regulations apply.

Next Steps

Presumably, benefit plan investors and IRAs have already filed any required 990-Ts for 2018 and 2019 based on the Notice and/or the Proposed Regulations. Except for the treatment of interests held on or before August 21, 2018, the Final Regulations may not require significant changes in the positions taken for investments already held by benefit plan investors and IRAs. Nevertheless, benefit plan investors and IRAs will want to review their tax filing positions based on the Final Regulations and, of course, consider how the Final Regulations apply to new investments. They also may want to identify how managers of their investment holdings can provide necessary information to facilitate future filings (*e.g.*, to better identify their ownership percentages in applying the 2% and 20% ownership thresholds described above).

Finally, benefit plan investors, IRA owners, and their advisers may want to devote attention to the impact on state tax filings going forward.