**Nonprofits & Tax-Exempt Organizations Alert**
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# Treasury, IRS Release Final UBTI 'Silo' Regulations

The Treasury Department and the IRS have posted an advance copy of final regulations in T.D. 9333 (Final Regulations) that provide guidance on how an exempt organization subject to the unrelated business taxable income (UBTI) tax determines whether it has more than one unrelated trade or business and, if so, how to separately calculate or "silo" revenue and expenses for each separate business under IRS Code Section 512(a)(6).

These regulations finalize, with modifications, proposed regulations that were issued in April 2020. (Read our client alert on the proposed regulations here.)

The Final Regulations adopt most of the same rules introduced by the proposed regulations, including the rule that exempt organizations use the first two digits of the North American Industry Classification System (NAICS) codes as the only methodology for identifying separate trade or business activities. The Final Regulations provide some additional guidance in this area, including:

- Exempt organizations are no longer restricted from changing an activity's two-digit NAICS code in the future (the proposed regulations allowed changes only for "unintentional errors"). In response to comments objecting to these restrictions, the Final Regulations allow exempt organizations to change their classifications as long as they report the change in the taxable year of the change in accordance with relevant forms and instructions.
- In the case of the sale of goods that are available both online and in stores, the separate, unrelated trade or business is identified by the goods sold in stores.
- In response to one commenter's example of a museum's space being available for rent, the IRS noted that income that is appropriately characterized as income from rentals is already generally exempt from UBTI under Section 512(b)(3). To the extent other services are provided, however, income from the use of space may cease to be rent from real property and instead take on the character of the services provided.

The Final Regulations also provided additional detail with respect to an exempt organization's investments. While they continue to treat an exempt organization's investment activities as a separate trade or business for purposes of Section 512(a)(6), and largely adopt the proposed rules for investment activities, the Final Regulations provide significant additional guidance on the rules provided for qualified partnership interests (QPI).

In general, for exempt organizations, the activities of a partnership are considered the activities of the exempt organization partners. Commenters on both Notice 2018-67 and the proposed regulations explained the difficulty of obtaining information regarding the trade or business activities of lower-tier partnerships. As a matter of administrative convenience, the proposed regulations permitted the aggregation of any QPI with all other QPIs, resulting in the treatment of the aggregate group of QPIs as a single investment activity.

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The QPI test focuses on determining whether an exempt organization significantly participates in a partnership, thereby indicating an ability to obtain the information needed from the partnership to determine whether a trade or business conducted by the partnership is an unrelated trade or business with respect to the exempt organization partner. To better reflect this intent, the Final Regulations changed the name of the control test to the "participation test," while largely leaving the actual rules of the test alone.

The participation test now says that a partnership interest is a QPI if the exempt organization (i) directly holds no more than 20% of the capital interest and (ii) does not significantly participate in the partnership. Many commenters urged Treasury and the IRS to increase the 20% threshold to 50%, but these requests were rejected. The Final Regulations do, however, expand a favorable "look through rule" from the proposed regulations, which permitted (but did not require) an exempt organization to aggregate the UBTI from de minimis, indirectly held QPIs with its directly held QPIs. The Final Regulations expand application of the look-through rule to indirectly held partnership interests that meet the requirements of the participation test with regards to the immediately higher-tier partnership that owns interest in that partnership. For purposes of the look-through rule, the participation test will apply tier by tier to the exempt organization's indirectly held partnership interests.

Finally, the Final Regulations adopted a popular rule from the proposed regulations, permitting an exempt organization with more than one unrelated trade or business to determine public support using either its UBTI calculated under the silo rules or its UBTI calculated in the aggregate. In adopting the rule, Treasury and the IRS acknowledged that Section 512(a)(6) was not intended to change congressional intent behind the public support test rules for exempt organizations.

The proposed regulations reserved two issues for further consideration, which the Final Regulations continued to be silent on. The first involves the allocation of expenses, depreciation, and similar items that are shared between an exempt activity and an unrelated trade or business or between more than one unrelated trade or business. The second issue relates to changes made to the Section 172 net operating loss (NOL) deduction by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136. Treasury and the IRS anticipate publishing a separate notice that will address these issues.

The regulations have been sent to the Federal Register for publication and will be effective on the date of publication.

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