Proposed Regulations Provide Guidance to Exempt Organizations on Identifying Separate Unrelated Trade or Businesses

May 5, 2020

On April 23, the Treasury Department and the Internal Revenue Service (the "IRS") issued helpful proposed regulations under section 512(a)(6) of the Internal Revenue Code (the "proposed regulations"). Section 512(a)(6) was enacted as part of the 2017 Tax Cut and Jobs Act (the "TCJA") and requires exempt organizations (including individual retirement accounts) to calculate unrelated business taxable income ("UBTI") separately with respect to each of their unrelated trades or businesses, thereby limiting the ability to use losses from one business to offset income or gain from another.[1] In August 2018, the Treasury Department and the IRS issued Notice 2018-67 (the "Notice"), which provided interim guidance on the application of section 512(a)(6). The proposed regulations liberalize and simplify the initial guidance in the Notice. In short:

1. Very helpfully, the proposed regulations use the two-digit North American Industry Classification System ("NAICS") codes as the primary method of identifying separate trades or businesses, rather than the six-digit codes suggested in the Notice. This reduces the numbers of trades or businesses from over 1,050 under the Notice to twenty under the proposed regulations, which will greatly reduce the compliance burden for many tax-exempt entities and enhance their ability to use losses.
2. The proposed regulations helpfully liberalize the rules contained in the Notice that allow tax-exempt entities to treat investment activities (including, in particular, "qualifying partnership interests" ("QPIs")) as a single trade or business (and thereby aggregate net income and gains and losses from those investment activities). However, the proposed regulations should clarify that traditional minority rights that may be held by a tax-exempt entity in an investment partnership do not disqualify an interest in that partnership from being a QPI.

The proposed regulations will apply to taxable years beginning on or after the date the regulations are published as final; however, taxpayers may rely on the proposed regulations before they are finalized. In addition, until the proposed regulations are finalized, exempt organizations may rely on a reasonable, good-faith interpretation of what constitutes a separate trade or business under current law or the methods described in the Notice for aggregating or identifying separate trades or businesses.

1. Aggregating UBTI from Trades or Businesses

A. Identification of Trades or Businesses Using Two-Digit NAICS Codes

Under section 512(a)(6), for purposes of calculating UBTI, an exempt organization can only aggregate items of income and deduction if they relate to the same trade or business. Other than with respect to investment activities and income received from controlled entities (discussed below), the proposed regulations generally adopt the NAICS two-digit sector codes as the primary method for identifying trades or businesses.[2]

Exempt organizations generally must identify each separate trade or business using only the two-digit NAICS sector code that most accurately describes the unrelated trade or business (and not the code that describes the exempt organization's general activities that are substantially related to its exempt purpose). Qualified retirement plans must use the NAICS two-digit sector code that most accurately describes the underlying trade or business regularly carried on by the plan or a partnership of which it is a member.[3]

The proposed regulations provide that an exempt organization will report each NAICS two-digit sector code only once. For example, a hospital system that operates multiple pharmacies may report all of the pharmacies under a single NAICS two-digit sector code (retail trade), together with any other retail trades with the same two-digit sector code, as a single unrelated trade or business, aggregating income and deductions across all of those business activities. Similarly, an exempt organization that may have used its intellectual property to produce different products may, in some cases, now be able to report the income and deductions associated with producing those products as a single trade or business. Once a trade or business is identified by a particular NAICS two-digit sector code, a taxpayer can only change that code by notifying the IRS and demonstrating both an unintentional error in choosing that code and that another sector code more accurately describes the trade or business.[4]

Currently, broad categories of business activities are represented by twenty NAICS two-digit sector codes;[5] initially, the Notice had proposed that trades or businesses be identified by the more specific NAICS six-digit code, representing over 1,050 potential trades or businesses. Accordingly, the move to the two-digit sector codes will greatly simplify the identification of trades or businesses, permitting exempt organizations to aggregate more of their business activities into a single trade or business and enhancing their ability to use losses realized by those business activities.

B. Investment Activities

Under the proposed regulations, all investment activities are treated as a single separate unrelated trade or business. For this purpose, "investment activities" are limited to the following three activities only: (i) direct or indirect investments in partnerships designated as QPIs, (ii) debt-financed properties, and (iii) qualifying S corporation interests.[6]

i. Partnership Interests

The proposed regulations permit, but do not require, an exempt organization to aggregate UBTI realized from all QPIs as a single trade or business in investments. Once an exempt organization opts to designate a partnership interest as a QPI (in accordance with a form and instructions that will be issued by the IRS), the exempt organization cannot use a NAICS two-digit sector code to identify the partnership's underlying trade or business unless and until the partnership interest is no longer a QPI. Because of this optionality, an exempt organization may want to evaluate the relative benefits of including the partnership interest in its investment activities, as opposed to part of a different trade or business, in light of its particular circumstances.

Under the proposed regulations, the following investments in partnerships[7] may be treated as QPIs (each of which are described below), so long as the exempt organization is not the general partner of the partnership:[8] (i) directly-held partnership interests that satisfy the de minimis test, (ii) directly-held partnership interests that satisfy the control test, and (iii) indirectly-held partnership interests identified under the look-through rule.[9]

First, under the de minimis test, a partnership interest may be treated as a QPI if the exempt organization directly holds no more than 2% of the capital interest and no more than 2% of the profits interest of that partnership. For this purpose, an exempt organization is not required to take into account interests in the partnership held by supporting organizations (as defined in section 509(a)(3)) or controlled entities (for section 512(b)(13) purposes) when determining whether it meets this 2% threshold.

Second, under the control test, a partnership interest directly held by an exempt organization may also be treated as a QPI if the exempt organization holds no more than 20% of the capital interest in the partnership and does not "control" the partnership.[10] To determine whether the 20% ownership threshold is met with respect to a partnership, the proposed regulations require exempt organizations to take into account the interests of supporting organizations or controlled entities that also hold a capital interest in that same partnership, unlike the approach for determining ownership under the de minimis test.[11] The proposed regulations identified the following four rights or powers that would be viewed by the IRS as indicative of control:

> (1) the exempt organization, by itself, may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership;
>
> (2) any of the exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time;
>
> (3) any of the exempt organization's officers, directors, trustees, or employees have rights to conduct the partnership's business at any time; or
>
> (4) 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.

In addition, the Preamble suggests that the control test is implicated if any member of the exempt organization's board also has the right to manage or conduct the business of a partnership in which the exempt organization is invested. We do not believe that the drafters intended to preclude a limited partner from having typical minority rights, such as the right to consent before the partnership changes its business, sells all or substantially all of its assets, or takes certain tax positions that could adversely affect the limited partner. We would hope that the final regulations clarify this point.

Third, if an exempt organization directly owns more than 20% of an interest in a partnership (and, accordingly, that partnership does not satisfy the control test) but the organization does not "control" that directly-held partnership, the organization may also be able to treat certain indirectly-held partnership interests as QPIs (and aggregate the UBTI realized from those indirectly-held partnership interests with its UBTI from other investment activities). Specifically, the proposed regulations allow an exempt organization to identify certain indirectly-held partnership interests (i.e., partnership interests owned by the above-referenced directly-held partnership) as QPIs if the de minimis test is met with respect to such indirectly-held partnership interests on a look-through basis (the "look-through rule").

Also, an exempt organization may generally rely on Schedules K-1 to determine its percentage interest in a partnership, unless the information about the percentage interest is not specifically provided (e.g., it is identified on the Schedule K-1 as "variable").

The proposed regulations generally adopt a transition rule that was provided under the Notice. Specifically, an exempt organization can treat a directly-held partnership interest acquired before August 21, 2018 as a single trade or business, even if that partnership directly or indirectly through lower-tier subsidiaries conducts multiple trades or businesses and the interest does not otherwise meet the de minimis test or the control test. In addition, the proposed regulations clarify that an exempt organization may apply the transition rule, even if its ownership percentage in the directly-held partnership changes.

An exempt organization may apply either the transition rule or the look-through rule, but not both, to a partnership interest that meets the requirements for both rules. Accordingly, the transition rule provides an opportunity for exempt organizations to identify any partnership interests that could fall in this category, and make appropriate determinations based on its own facts and circumstances.

An exempt organization may rely on the transition rule until the first day of its first taxable year beginning after the final regulations are published. Once the transition rule expires, we expect that all partnership interests held by an exempt organization would be subject to the final regulations (and the exempt organization would need to either designate its partnership interest as a QPI, if it so qualified, or identify any trades or business conducted by the partnership with NAICS two-digit sector codes), regardless of when the partnership interests were acquired.

ii. Debt-Financed Income

As general rule, under section 512(b)(4), income (including dividends, interest, rents, royalties, and capital gains that are not ordinarily treated as UBTI) that is derived from investments funded at least in part by indebtedness and other forms of unrelated debt-financed income are treated as UBTI. Under the proposed regulations, all of an exempt organization's UBTI from debt-financed properties (as defined in section 514) would be included as investment activities. Accordingly, the UBTI from debt-financed income may be aggregated with the UBTI derived from an exempt organization's QPIs and qualifying S corporation interests.

However, the Preamble notes that the rental of debt-financed real and personal property is not an investment activity under the proposed regulations. Accordingly, the rental activity should be treated as a separate trade or business that is identified using the NAICS two-digit sector codes.[12]

C. Other Trades or Businesses

Under the proposed regulations, all interest, annuities, royalties, and rents paid by a controlled entity (as described in section 512(b)(13), but generally more than 50% owned) to a controlling exempt organization are treated as UBTI from a single trade or business, even if the controlled entity would otherwise be treated as engaging in multiple unrelated trades or businesses.

In addition, insurance income that is treated as UBTI under section 512(b)(17) is generally treated as having been received in a single unrelated trade or business, regardless of whether the insurance income is received from more than one controlled foreign corporation.[13]

2. Net Operating Losses

Under the proposed regulations, an exempt organization must identify net operating losses ("NOLs") separately with respect to each of its unrelated trades or businesses. In addition, the proposed regulations provide ordering rules for applying NOLs if an exempt organization has generated NOLs both before January 1, 2018 ("pre-2018 NOLs") and after December 31, 2017 ("post-2017 NOLs").

Under the proposed regulations, the pre-2018 NOLs, which are subject to a 5-year carryforward, are applied first against the exempt organization's total UBTI (i.e., the sum of the UBTI generated by each of the separate trades or businesses). Then, any post-2017 NOLs, which may be carryforward indefinitely, are deducted against the UBTI from the specific trade or business that generated those post-2017 NOLs. The proposed regulations clarify that pre-2018 NOLs are deducted from total UBTI in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year. However, it is unclear how the pre-2018 NOLs should be apportioned among the UBTI attributable to each of an exempt organization's multiple trades or businesses if the exempt organization also has post-2017 NOLs that need to be applied against a particular trade or business.

The Treasury Department and the IRS expect to provide additional guidance on how the NOL ordering rules described above interact with the changes to the NOL limitations implemented by the CARES Act.[14]

3. Other Provisions

- ***Allocation of Directly Connected Deductions***. The Treasury Department and the IRS intend to issue further guidance on the allocation of expenses between exempt and non-exempt activities, and among unrelated trade or businesses. Until then, the proposed regulations allow an exempt organization to allocate deductions on any reasonable basis. However, the proposed regulations clarify that, for this purpose, the "unadjusted gross-to-gross" method is not a reasonable allocation method.[15]
- ***Total UBTI and the Charitable Contribution Deduction***. Exempt organizations are generally permitted to take a deduction for charitable contributions against their UBTI. The proposed regulations clarify that this deduction is not allocated among unrelated trades or businesses and is instead deducted against an exempt organization's total UBTI (i.e., after application of section 512(a)(6)). The treatment of excess contribution carryovers, especially if an exempt organization also has NOL carryforwards, remains unclear.

- ***Subpart F Income and Global Intangible Low-Taxed Income ("GILTI") Inclusions are Treated as Dividends***. The proposed regulations treat Subpart F income as dividends (consistent with its private rulings and the Notice) and treat GILTI inclusions as dividends (also consistent with the Notice). Accordingly, they generally are not included in UBTI (except to the extent the investment in the underlying foreign corporation is debt financed).
- ***Public Support***. To address the concern that an increase in unrelated business income due to the limitation on aggregating losses and gains from various separate unrelated trades or businesses can impact the public support calculation under section 509(a)(1) and (a)(2), the proposed regulations allow organizations to aggregate net income and net losses from all of the unrelated business activities for purposes of calculating public support.

* * *

The Treasury Department and the IRS have requested comments on the proposed regulations by June 23, 2020.

---

[1] The Treasury Department and the IRS considered, but did not adopt, a de minimis exception for exempt organizations that do not have significant gross UBTI. In addition, the proposed regulations include a special set of rules that apply to social clubs, voluntary employee benefit associations, and supplemental unemployment compensation benefits trusts. Those rules are beyond the scope of this client alert.

[2] The NAICS is an industry classification system that uses six-digit codes to classify economic activities. Each digit in the NAICS six-digit code describes an industry with increasing specificity. The industry sector is identified by the first two digits of the six-digit NAICS code. The third digit identifies the subsector; the fourth digit identifies the industry group; and the fifth and sixth digits designate the particular industry and, if relevant, a designation relating to differences among Canada, Mexico, and the United States.

[3] A qualified retirement plan refers to a trust that is exempt from tax under section 501(a) and described in section 401(a). As such plans generally realize most (if not all) of their UBTI through investment activities, the proposed regulations note that a qualified retirement plan's investment activities may be its only unrelated trade or business and not subject to section 512(a)(6). If such plan engages directly in other unrelated trades or businesses or has non-qualifying partnership (or S corporation) interests that cannot be treated as investment activities under the proposed regulations, section 512(a)(6) would apply to such trades or businesses.

[4] It is unclear what recourse an exempt organization would have if the nature of the unrelated business activity changes.

[5] Representative sector codes include the following: Manufacturing (31-33), Retail Trade (44-45) and Transportation and Warehousing (48-49). Other sectors include Finance and Insurance (52), Real Estate and Rental and Leasing (53), Educational Services (61), Health Care and Social Assistance (62), and Arts, Entertainment, and Recreation (71).

[6] Stock in S corporation is a qualifying S corporation interest if the stock ownership meets the requirements provided in the de minimis test or the control test for QPIs. Each non-qualifying S corporation interest will be treated as an interest in a separate unrelated trade or business.

[7] For these purposes, "partnerships" include limited liability companies and other entities that are classified as partnerships for federal income tax purposes.

[8] Although the proposed regulations are currently silent, we would expect that the IRS would clarify in final regulations that a limited liability company that is treated as a partnership in which an exempt organization is the managing member does not qualify as a QPI. It appears that if a regarded entity that is wholly owned or otherwise controlled by an exempt organization acts as the general partner of a partnership, that partnership would be eligible to be treated as a QPI under the proposed regulations.

[9] Consistent with the Notice, the proposed regulations permit aggregation of UBTI from certain partnership interests with multiple trades or businesses, including ones conducted by lower-tier partnerships, and any QPIs may be aggregated with all other QPIs and treated as a single trade or business for purposes of section 512(a)(6)(A).

[10] The Notice had previously focused on whether the exempt organization had control ***or influence*** over a partnership. The proposed regulations dropped the “influence” requirement from the control test.

[11] However, in contrast to the Notice, interests held by disqualified persons (as defined in section 4958(f)) in the same partnership are no longer aggregated with the ownership of the exempt organization for this purpose.

[12] For example, unrelated debt-financed income does not include rents from real and personal property purchased with debt financing if more than 50% of the total rent received or accrued under a lease is attributable to personal property because those rents are already included in UBTI. In this case, the exempt organization must identify such unrelated trade or business using the NAICS two-digit code for real estate rental and leasing, rather than treating as a debt-financed property and including the rent as UBTI from investment activities.

[13] Section 512(b)(17) provides that income earned by a controlled foreign corporation that insures third-party risk will be treated as UBTI to the extent the amount so included is attributable to insurance income which, if derived directly by the exempt organization, would be treated as UBTI. The Preamble notes that an exempt organization may not aggregate the insurance income included in UBTI with respect to the controlled foreign corporation with any insubstantial commercial-type insurance activities directly conducted by the exempt organization.

[14] The TCJA made extensive changes to section 172, which included prohibiting the carryback of NOLs and limiting the NOL deduction to 80% of taxable income. The CARES Act temporarily repeals these limitations by generally allowing NOLs from 2018, 2019, and 2020 to be carried back for five years and fully offset taxable income, rather than only 80% of taxable income.

[15] For example, an organization that charges different prices for the same good or service depending on whether the offering is an exempt-related or -unrelated activity should adjust the per “unit” price of the good or service so they are the same. Otherwise, the per-unit price of the exempt-unrelated good or service is likely to be higher, even though the costs of providing that good or service are the same on a per-unit basis, overstating the percentage of fixed costs associated with that good or service.

- **Stuart L. Rosow**
- **David S. Miller**
  Partner
- **Amanda H. Nussbaum**
  Partner
- **Janicelynn Asamoto Park**
  Partner
- **Bowon Koh**
  Associate