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IRS Proposes Regulations for U.S. Tax-Exempt Organizations with Multiple Unrelated Businesses

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The IRS has proposed regulations (Proposed Regulations) on how a tax-exempt organization should classify multiple business and investment activities for the purpose of determining its unrelated business taxable income (UBTI). The Proposed Regulations are based on previous guidance issued by the IRS in Notice 2018-67 (Notice).

Before the *Tax Cuts and Jobs Act of 2017* (TCJA) was enacted, a tax-exempt organization was permitted to aggregate its income and losses from all of its business activities that were not related to its exempt purpose. The TCJA introduced a new provision in section 512(a)(6) that requires a tax-exempt organization to determine its UBTI with respect to each unrelated trade or business on a separate basis, which effectively prevents the tax-exempt organization from offsetting income from one unrelated trade or business with losses from another.

This rule has attracted criticism from commentators who believe that the increased revenue raised under this rule would be put to better use by the tax-exempt organizations themselves, which generally operate in the public interest. The Proposed Regulations, recognizing that criticism, are taxpayer-favourable and are expected to ease tax-exempt organizations' burden of complying with section 512(a)(6).

Discussion

The Proposed Regulations provide that, for the purposes of section 512(a)(6), a tax-exempt organization's activities are distinguished on the basis of the coding system known as the North American Industry Classification System (NAICS). Under NAICS, each industrial activity that is part of the North American economy is represented by a six-digit code. The first two digits of the code designate the sector of the economy; the third digit designates the subsector; the fourth digit designates the industry group; the fifth digit designates the industry; and the last digit is used to distinguish between variations within an industry.

Business Activities

The Notice originally required tax-exempt organizations to classify their business activities by the full six-digit NAICS code. The Proposed Regulations, however, permit tax-exempt organizations to classify their business activities on the basis of just the first two digits of the NAICS code, which should substantially simplify compliance with section 512(a)(6). So, for example, under the Notice, a tax-exempt organization would have to compute its UBTI separately for strawberry farming (NAICS code 111333) and tree nut farming (NAICS code 111335), whereas under the Proposed Regulations, all activities relating to agriculture, forestry, fishing and hunting (NAICS code 11) can be aggregated, including strawberry farming, tree nut farming, chicken egg production, logging, fishing and many other activities.

Investment Activities

Under the Proposed Regulations, a tax-exempt organization's investment activities are not subject to classification by NAICS codes and are treated as a separate unrelated trade or business. (As noted below, a tax-exempt organization may elect to treat the activities of certain partnerships as either investment activities or activities subject to classification under NAICS.) For this purpose, the Proposed Regulations define investment activities as (i) qualifying partnership interests (QPIs), (ii) debt-financed properties and (iii) qualifying S corporation interests.

- **QPIs**. The Proposed Regulations provide that a tax-exempt organization's partnership interest is a QPI if either (a) the tax-exempt organization holds no more than 2% of the capital or profits interest in the partnership (subject to a look-through rule for tiered partnership structures) or (b) the tax-exempt organization holds no more than 20% of the capital interest in the partnership directly and does not have any control or influence over the partnership. The Proposed Regulations permit, but do not require, a tax-exempt organization to aggregate the UBTI that it receives from QPIs, although once that organization elects to aggregate, it must continue to do so. If a partnership interest held by a tax-exempt organization does not qualify as a QPI, or if the tax-exempt organization does not elect to aggregate UBTI from a QPI, then the tax-exempt organization must classify the activities of the partnership on the basis of the NAICS codes, as described above.
- **Debt-Financed Properties**. If a tax-exempt organization finances the acquisition of property with debt, income from that property is generally treated as UBTI. The Proposed Regulations treat the holding of debt-financed property as an investment activity of a tax-exempt organization and, accordingly, UBTI from debt-financed property is aggregated with UBTI from other investment activities.
- **Qualifying S Corporation Interests**. The Proposed Regulations generally treat income from an interest in each S corporation held by a tax-exempt organization as a separate trade or business for the purposes of section 512(a)(6). An exception is provided, however, for "qualifying S corporation interests," which are interests in S corporations that meet requirements similar to the requirements for a partnership interest to be a QPI (i.e., the tax-exempt organization most hold no more than 2% of the S corporation stock, or hold no less than 20% of the S corporation stock and not control the S corporation).

UBTI from investment activities is aggregated, which means that losses from one investment activity may offset income from another investment activity.

Subpart F and GILTI

Dividends, interest and certain other income are expressly excluded from UBTI (unless produced by debt-financed property or under certain other circumstances) and, accordingly, are not subject to the rules on classifying income from unrelated trades or businesses. The Proposed Regulations clarify that subpart F and GILTI (global intangible low-taxed income) inclusions are treated as dividends for the purpose of this rule.

Effective Dates

Until the beginning of the first tax year after final regulations are issued, tax-exempt organizations generally can rely on the Proposed Regulations, the Notice or a good-faith interpretation of the applicable rules.

Concluding Comments

The rule for separate unrelated trades or businesses of a tax-exempt organization under section 512(a)(6) has been criticized as unnecessarily burdensome on taxpayers. The Proposed Regulations represent a sober effort by the IRS to balance the congressional intent behind section 512(a)(6) with the needs of tax-exempt organizations.

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