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CLIENT ALERT

IRS Proposed Regulations Provide Guidance on Separate Calculation of Unrelated Business Taxable Income for Each Trade or Business

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On Thursday, April 23, the IRS released proposed regulations (the "Proposed Regulations") related to section 512(a)(6) of the Internal Revenue Code of 1986, as amended (the "Code"), which requires a tax-exempt organization to compute its unrelated business taxable income separately with respect to each unrelated trade or business in which it is engaged. Prior to enactment of section 512(a)(6) of the Code as part of the Tax Cuts and Jobs Act of 2017, a tax-exempt organization was permitted to compute its unrelated business taxable income on an aggregated basis across all unrelated trades or businesses in which it engaged so that losses from one business could be used to offset income from another. The Proposed Regulations are intended to provide guidance about how to make this newly required separate computation.

The Proposed Regulations adopt much of the guidance that the IRS previously provided on August 21, 2018 in Notice 2018-67 (the "Notice"). A brief description of the highlights of the Proposed Regulations follows.

Determination of Separate Trade or Business

The Proposed Regulations require a tax-exempt organization to identify each of its separate unrelated trades or businesses using the first two digits of the North American Industry Classification System code (NAICS 2-digit code). There are currently twenty 2-digit sector codes that describe industries such as, for example, Accommodation and Food

Services; Retail Trade; Wholesale Trade; Manufacturing; Construction; Mining, Quarrying, and Oil and Gas Extraction; Agriculture, Forestry, Fishing and Hunting; and Real Estate and Rental and Leasing.

This is a change from the Notice which provided that the NAICS 6-digit code should be used. Because each digit in the NAICS code provides more specificity, this change should enable tax-exempt organizations to aggregate more unrelated trades or businesses for purposes of determining their unrelated trade or business taxable income.

Investment Activities

The Proposed Regulations provide special rules to determine unrelated business taxable income with respect to investment activities. A tax-exempt organization is permitted to aggregate unrelated trade or business profits and losses from certain investment activities – its qualifying partnership interests, its qualifying S corporation interests and its debt-financed property or properties – as if these investment activities constituted a single unrelated trade or business.

Qualifying Partnership Interests. A “qualifying partnership interest” is a direct interest in a partnership that meets the requirements of either the “de minimis test” or the “control test.”

De Minimis Test. The “de minimis” test is met if a tax-exempt organization does not own more than 2% of the profits interest or capital interest in a partnership.

Control Test. The “control test” is met if a tax-exempt organization does not own more than 20% of the capital interest in a partnership and does not control the partnership (departing from the “influence or control” test of the Notice). “Control” is determined based on all facts and circumstances, but a tax-exempt organization is automatically deemed to control a partnership if any of the following is true:

- The tax-exempt organization may, by itself, require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership;
- Any of the tax-exempt organization’s officers, directors, trustees or employees has the right to participate in the management of the partnership at any time;
- Any of the tax-exempt organization’s officers, directors, trustees or employees has the right to conduct the partnership’s business at any time; or
- The tax-exempt organization has, by itself, the power to appoint or remove any of the partnership’s officers or employees or a majority of its directors.

Indirect Interests in Partnerships. A qualifying partnership interest can also include an interest in a lower-tier partnership that a tax-exempt organization holds through an upper-tier partnership, provided that certain requirements are met.

Look-through De Minimis Test. A tax-exempt organization may look through an upper-tier partnership in which it directly owns more than a 20% capital interest but that it does not control to determine whether the de minimis test is met with respect to underlying partnerships. For example, if a tax-exempt organization directly owns 50% of the capital of a partnership that it does not control, and that partnership owns 4% of the profits and capital interests in an underlying partnership, then the tax-exempt organization will be deemed to own 2% of the underlying partnership and the de minimis test will be met with respect to the underlying partnership.

Other Indirect Partnership Interests. Note that the Proposed Regulations raise a question regarding how unrelated business taxable income will be computed if a tax-exempt organization makes its investments through an aggregator partnership vehicle. If a tax-exempt organization uses a partnership vehicle that it controls to make investments, then it appears that the Proposed Regulations may not permit the tax-exempt organization to apply the control test or the de minimis test on a look-through basis. Further, as noted above, even in the case where there is no control at the upper-tier partnership level, only the de minimis test can be applied on a look-through basis. For tax-exempt organizations that invest in private equity and venture capital funds through a controlled co-investment vehicle organized as a partnership with other related tax-exempt organizations or with substantial contributors, the inability to look through an upper-tier partnership would mean that any underlying investment funds in which they invest would not be able to be aggregated for purposes of computing unrelated trade or business income. This could result in additional tax and additional administrative burden. However, at least during the transition period described below (ending after final regulations are published), a tax-exempt organization may treat any such co-investment partnerships as a single trade or business under the Proposed Regulations.

Related Party Aggregation. For purposes of determining the percentage ownership by a tax-exempt organization for the control test, the organization needs to include ownership by any of its supporting organizations (within the meaning of section 509(a)(3) of the Code) and by any of its controlled entities (within the meaning of section 512(b)(13)(D) of the Code). The Notice had required aggregation with disqualified persons as well.

Transition Rule. The Proposed Regulations permit a tax-exempt organization to treat – during the transition period – a directly-held partnership interest acquired prior to August 21, 2018 as a separate unrelated trade or business, regardless of the number of unrelated trades or businesses directly or indirectly conducted by the partnership, even if it is not a qualifying partnership interest. The transition period will end on the first day of the tax-exempt organization’s first taxable year beginning after the date of the publication of the final regulations under section 512(a)(6).

S Corporations. Income from one or more S corporations may be aggregated with other investment income if the tax-exempt organization’s interest in the S corporation meets either the de minimis or the control test described above.

Debt Financed Income. All of a tax-exempt organization's unrelated debt financed income, loss and gain within the meaning of section 514 of the Code is treated as part of the tax-exempt organization's investment activity and can be aggregated with such income from its qualifying partnership interests and qualifying S corporation interests.

CFC Insurance Income. All insurance income received by a tax-exempt organization from a controlled foreign corporation that is treated as unrelated trade or business income under section 512(b)(17) of the Code will be treated as income derived from a separate trade or business (and must be treated separately from any income the organization may have earned from the direct conduct of insurance business).

Net Operating Losses

The Proposed Regulations provide that for taxable years beginning after December 31, 2017, a tax-exempt organization with more than one unrelated trade or business must determine the net operating loss deduction permitted by sections 172(a) and 512(b)(6) separately with respect to each of its unrelated trades or businesses. The Proposed Regulations clarify that a tax-exempt organization that has losses arising in a taxable year beginning before January 1, 2018 ("pre-2018 NOLs") and losses arising in a taxable year beginning after December 31, 2017 ("post-2017 NOLs") is permitted to deduct its pre-2018 NOLs from its total unrelated trade or business income before deducting any post-2017 NOLs with regard to its separate unrelated trade or business income. The Proposed Regulations mandate that pre-2018 NOLs be taken against total unrelated trade or business income "in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year."

The Preamble to the Proposed Regulations notes that due to the recent changes made pursuant to the Coronavirus Aid, Relief, and Economic Security Act to the way net operating losses are computed under section 172 of the Code (the 80% deduction limit has been temporarily repealed and carrybacks of NOLs are again permitted with respect to losses arising in taxable years beginning after December 31, 2017 and before January 1, 2021), the Treasury Department and the IRS are further considering how these changes affect the calculation of unrelated trade or business income and may issue additional guidance on the issue.

Subpart F Income and GILTI

The Proposed Regulations also amend the Treasury Regulations under section 512 of the Code to clarify that inclusions of subpart F income under section 951(a)(1)(A) and inclusions of global intangible low-taxed income under section 951A(a) of the Code are treated in the same manner as dividends and are therefore exempt from unrelated trade or business income tax (unless they are debt-financed).

Public Support Test

Net income from unrelated business activities can be a factor in determining whether a tax-exempt organization meets the public support tests set forth in sections 509(a)(1) and (2) of the Code. Because application of section 512(a)(6) of the Code may result in increased unrelated trade or business income for organizations, it could be more difficult for certain organizations to meet the public support test. According to the Proposed Regulations' Preamble, "[t]he Treasury Department and the IRS are not aware of any intent of Congress to change the public support test when enacting 512(a)(6)." Therefore, the Proposed Regulations also amend the regulations under sections 170 and 509 of the Code to provide that for purposes of those sections, unrelated trade or business income can continue to be computed on an aggregated basis.

Individual Retirement Accounts

The Proposed Regulations also clarify that the definition of unrelated trade or business applies to individual retirement accounts.

Comments and Effective Date

Comments on the Proposed Regulations must be provided to the IRS by June 23, 2020. The Proposed Regulations will apply to taxable years beginning on or after the date on which the Proposed Regulations are published in the Federal Register as final regulations. For taxable years beginning before that date, a tax-exempt organization may rely on a reasonable, good-faith interpretation of sections 511 through 514 of the Code, on the Proposed Regulations or on the Notice.

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If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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