

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Parts 1 and 602**

[REG–106864–18]

RIN 1545–BO79

Unrelated Business Taxable Income Separately Computed for Each Trade or Business**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance on how an exempt organization subject to the unrelated business income tax described in section 511 of the Internal Revenue Code (Code) determines if it has more than one unrelated trade or business, and, if so, how the exempt organization calculates unrelated business taxable income. The proposed regulations also clarify that the definition of “unrelated trade or business” applies to individual retirement accounts. Additionally, the proposed regulations provide that inclusions of subpart F income and global intangible low-taxed income are treated in the same manner as dividends for purposes of section 512. The proposed regulations affect exempt organizations.

DATES: Written or electronic comments and requests for a public hearing must be submitted by June 23, 2020.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG–106864–18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG–106864–18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed rules, Jonathan A. Carter at (202) 317–5800; concerning submissions of comments and requests for a public hearing, Regina Johnson at (202) 317–5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:**Background**

Under section 501(a) of the Code, organizations described in sections 401(a) and 501(c) generally are exempt from federal income taxation. However, section 511(a)(1) imposes a tax (computed as provided in section 11) on the unrelated business taxable income (UBTI) of organizations described in section 511(a)(2), which includes organizations described in sections 401(a) and 501(c) (other than a trust described in section 511(b) or an instrumentality of the United States described in section 501(c)(1)), as well as state colleges and universities. Additionally, section 511(b)(1) imposes a tax (computed as provided in section 1(e)) on the UBTI of trusts described in section 511(b)(2), which describes trusts that are exempt from federal income taxation under section 501(a) and which, if it were not for such exemption, would be subject to subchapter J of chapter 1 of the Code (relating to estates, trusts, beneficiaries, and decedents). Organizations described in section 511(a)(2) and trusts described in section 511(b)(2) are collectively called “exempt organizations” or “organizations” throughout this preamble, unless otherwise stated.¹

Definitions of UBTI

Section 512 provides two different definitions of UBTI—one in section 512(a)(1), which applies to most exempt organizations, and one in section 512(a)(3), which applies only to social clubs described in section 501(c)(7), voluntary employees’ beneficiary associations (VEBAs) described in section 501(c)(9), and supplemental unemployment compensation benefits trusts (SUBs) described in section 501(c)(17).

Section 512(a)(1) defines UBTI as the gross income derived by any exempt organization from an unrelated trade or business regularly carried on by it, less the deductions allowed by chapter 1 of the Code (chapter 1) that are directly connected with the carrying on of such trade or business, both computed with the modifications described in section 512(b). Section 513(a) generally defines “unrelated trade or business” as any trade or business the conduct of which is not substantially related (aside from

¹ Section 408(e) states that an individual retirement account (IRA) is subject to the taxes imposed by section 511. Accordingly, any reference to an exempt organization in this preamble includes an IRA, without regard to whether it is a traditional IRA, Roth IRA, simplified employee pension (SEP-IRA), or savings incentive match plan for employees (SIMPLE IRA). See section 9 of this preamble for more information.

the need of such exempt organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such exempt organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of a state college or university, to the exercise or performance of any purpose or function described in section 501(c)(3)). However, in the case of a trust that is exempt from tax under section 501(a) and described in section 401(a) (qualified retirement plans) or section 501(c)(17) (SUBs), section 513(b) defines “unrelated trade or business,” as any trade or business regularly carried on by such trust or by a partnership of which it is a member. Section 1.513–1(b) generally provides that, for purposes of section 513, the term “trade or business” has the same meaning as in section 162.

By contrast, section 512(a)(3)(A) defines UBTI as the gross income (excluding exempt function income), less the deductions allowed by chapter 1 that are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications described in section 512(b)(6) (net operating loss (NOL) deduction), (b)(10) (charitable contribution deduction by exempt organizations), (b)(11) (charitable contribution deduction by certain trusts), and (b)(12) (specific deduction). Accordingly, UBTI under section 512(a)(3) is not limited to the gross income derived by an exempt organization from any unrelated trade or business regularly conducted by it. Thus, any gross income that is not exempt function income (nonexempt function income) is UBTI under section 512(a)(3).

Unrelated Trades or Businesses Conducted Indirectly Through Another Entity

An exempt organization may conduct an unrelated trade or business directly or indirectly through another entity, such as a partnership (including any entity treated as a partnership for federal tax purposes). Section 512(c) provides that, if a trade or business regularly carried on by a partnership of which an exempt organization is a partner is an unrelated trade or business with respect to such exempt organization, the exempt organization includes in UBTI—subject to the exceptions, additions, and limitations of section 512(b)—its distributive share of partnership gross income (whether or not distributed) and partnership deductions directly connected with

such gross income. See § 1.512(c)-1 (describing how UBTI is calculated in a situation in which an exempt organization's distributive share of partnership income consists of both UBTI and income that is excluded from the calculation of UBTI). In determining whether a partnership conducts a trade or business that is an unrelated trade or business with respect to an exempt organization partner, the exempt organization would use the applicable definition of "unrelated trade or business" in section 513(a) or (b). Section 512(c) applies regardless of whether an exempt organization is a general or limited partner. See Rev. Rul. 79-222, 1979-2 C.B. 236.

Calculation of UBTI

An exempt organization may engage in more than one unrelated trade or business. Prior to the enactment of section 512(a)(6), an exempt organization deriving gross income from the regular conduct of two or more unrelated trades or businesses calculated UBTI by determining its aggregate gross income from all such unrelated trades or businesses and reducing that amount by the aggregate deductions allowed with respect to all such unrelated trades or businesses. See § 1.512(a)-1(a). However, section 512(a)(6), which was added to the Code by section 13702 of Public Law 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), enacted December 22, 2017, changed this calculation for exempt organizations with more than one unrelated trade or business so that, in the case of any exempt organization with more than one unrelated trade or business:

(A) UBTI, including for purposes of determining any NOL deduction, shall be computed separately with respect to each trade or business and without regard to section 512(b)(12) (allowing a specific deduction of \$1,000),

(B) The UBTI of such exempt organization shall be the sum of the UBTI so computed with respect to each trade or business, less a specific deduction under section 512(b)(12), and

(C) For purposes of section 512(a)(6)(B), UBTI with respect to any such trade or business shall not be less than zero.

Thus, under section 512(a)(6), an exempt organization is no longer permitted to aggregate income and deductions from all unrelated trades or businesses when calculating UBTI. Section 512(a)(6) applies to taxable years beginning after December 31, 2017, but not to NOLs arising before January 1, 2018, that are carried over to

taxable years beginning on or after such date. See section 13702(b) of the TCJA.

In August 2018, the Treasury Department and the IRS issued Notice 2018-67 (2018-36 IRB 409 (Sept. 4, 2018)), which discussed and solicited comments regarding various issues arising under section 512(a)(6) and set forth interim guidance and transition rules relating to that section. The Treasury Department and the IRS received 24 comments in response to Notice 2018-67 and considered these comments in drafting these proposed regulations. Some of these comments discussed the interaction between section 512(a)(6) and (7), which was also enacted by the TCJA and provided that an exempt organization's UBTI is increased by any amount for which a deduction is not allowable under chapter 1 by reason of section 274 and which is paid or incurred by such exempt organization for certain disallowed fringes. These comments are not discussed because section 512(a)(7) was repealed on December 20, 2019. See Further Consolidated Appropriations Act, 2020, Division Q, Public Law 116-94, 133 Stat. 2534 (2019) (retroactively effective to date of enactment of the TCJA). The remaining comments are discussed in the Explanation of Provisions and Comment Summary. The comments are available for public inspection upon request.

Explanation of Provisions and Summary of Comments

Section 512(a)(6) requires an exempt organization with more than one unrelated trade or business to first calculate UBTI separately with respect to each such trade or business, without regard to the specific deduction generally allowed under section 512(b)(12). The Conference Report explains that "[t]he organization's [UBTI] for the taxable year is the sum of the amounts (not less than zero) computed for each separate trade or business, less the specific deduction allowed under section 512(b)(12)." H.R. Rep. No. 115-466 (2017), at 548. Section 512(a)(6) continues to allow an NOL deduction, but "only with respect to a trade or business from which the loss arose." *Id.* Thus, the legislative history states that "a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year." *Id.* at 548. Because section 512(a)(6) disallows the aggregation of income and deductions from all unrelated trades or businesses, these proposed regulations revise § 1.512(a)-1(a) to state that, in the case of an organization with more than one

unrelated trade or business, UBTI is calculated separately with respect to each such trade or business as provided in new proposed § 1.512(a)-6.

Congress did not provide explicit criteria for determining whether an exempt organization has "more than one unrelated trade or business" or how to identify "separate" unrelated trades or businesses for purposes of calculating UBTI in accordance with section 512(a)(6).² Accordingly, these proposed regulations establish the method for determining whether an exempt organization has more than one unrelated trade or business for purposes of section 512(a)(6) and identifying separate unrelated trades or businesses for purposes of calculating UBTI under this section. These proposed regulations also clarify that, for purposes of the unrelated business income tax generally and the application of section 512(a)(6) specifically, an individual retirement plan (IRA) described in section 408(e) uses the definition of "unrelated trade or business" in section 513(b) applicable to trusts. Additionally, these proposed regulations clarify that inclusions of subpart F income under section 951(a)(1)(A) and global intangible low-taxed income (GILTI) under section 951A(a) are treated in the same manner as dividends for purposes of section 512(b)(1).

1. Separate Unrelated Trade or Business

There is no general statutory or regulatory definition of what activities constitute a "trade or business" for purposes of the Code. Whether an activity constitutes a trade or business may vary depending on which Code section is involved. See generally *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987). Section 1.513-1(b) of the current Treasury regulations (promulgated in 1967) states that, "for purposes of section 513, the term 'trade or business' has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."

Notice 2018-67 permitted a reasonable, good-faith interpretation of sections 511 through 514, considering all the facts and circumstances, when determining whether an exempt organization has more than one unrelated trade or business for purposes

² The Joint Committee on Taxation's General Explanation of Public Law 115-97 states that "it is intended that the Secretary issue guidance concerning when an activity will be treated as a separate unrelated trade or business for purposes of [section 512(a)(6)]." Staff of the Joint Committee on Taxation, General Explanation of Public Law 115-97 (December 2018), at 293.

of section 512(a)(6). At the same time, Notice 2018–67 stated that the Treasury Department and the IRS were considering the use of the North American Industry Classification System (NAICS) codes as a method for determining whether an exempt organization has more than one unrelated trade or business for purposes of section 512(a)(6) and for purposes of calculating UBTI under section 512(a)(6)(A). NAICS is an industry classification system for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy that results from a cooperative effort between Canada, Mexico, and the United States. See Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017) (2017 NAICS Manual), available at https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf. The structure of NAICS is hierarchical, using a six-digit coding system. *Id.* at 16, 18, & 20. NAICS divides the economy into 20 sectors. *Id.* at 3. The first two digits of the code designate the sector, each of which represents a general category of economic activity, including retail trade (44–45); real estate and rental and leasing (53); health care and social assistance (62); and accommodation and food services (72). *Id.* at 16 & 20. The third digit designates the subsector; the fourth digit designates the industry group; and the fifth digit designates the NAICS industry. Any establishment is usually classified down to the NAICS five-digit industry level classification, using the classification of the industry that best matches its primary activity. When applicable, the sixth digit is used to designate the national industry, to reflect differences between the countries. A zero as the sixth digit generally indicates that the NAICS industry and the U.S. industry are the same. *Id.* at 18. Accordingly, each digit of the NAICS 6-digit codes describes an industry with increasing specificity.

In Notice 2018–67, the Treasury Department and the IRS provided that a reasonable, good-faith interpretation included using the most specific level—six-digit codes (NAICS 6-digit codes). The Treasury Department and the IRS also requested comments regarding rules to identify separate trades or businesses that achieve the intent of Congress in enacting section 512(a)(6) and that are administrable for exempt organizations and the IRS. As discussed further in section 1.a of this preamble, methods commenters suggested included devising a facts and

circumstances test along with a clearly defined safe harbor, adopting principles described in various Code sections (including sections 183 and 469), using the groupings described in Form 14018, “Compliance Questionnaire Colleges and Universities,” and using less than six digits of the NAICS codes.

After considering the comments, the Treasury Department and the IRS continue to view an identification method based on NAICS codes as administrable for exempt organizations and the IRS. Moreover, in response to comments regarding the burden related to the specificity of NAICS 6-digit codes, the proposed regulations provide that an exempt organization generally will identify its separate unrelated trades or businesses using the first two digits of the NAICS codes (NAICS 2-digit codes).

a. The North American Industry Classification System (NAICS)

Most commenters that discussed NAICS supported using the NAICS codes to identify separate unrelated trades or businesses for purposes of section 512(a)(6). Nonetheless, several commenters generally opposed this proposed method. These commenters argued that the NAICS codes were not created to define “trade or business” for UBTI purposes and therefore fail to sufficiently describe the full range of possible unrelated trades or businesses engaged in by exempt organizations. While the Treasury Department and the IRS recognize that the NAICS codes were not specifically designed for use under section 512(a)(6), the Treasury Department and the IRS continue to believe that using the NAICS codes is appropriate because NAICS “is a comprehensive [classification] system covering all economic activities.” 2017 NAICS Manual, at 14. Additionally, the broad scope of activities covered by the NAICS 2-digit codes should cover all the unrelated trade or business activities conducted by exempt organizations.

The NAICS codes were developed, in coordination with Canada and Mexico, by the Office of Management and Budget (OMB) and are managed by the United States Census Bureau. The OMB reviews and updates the NAICS codes as appropriate every five years and, at times, may remove codes. *Id.* at 78. In responding to the NAICS 6-digit codes discussed in Notice 2018–67, some commenters expressed concern that the Treasury Department and the IRS do not control NAICS and that this could adversely impact organizations using the codes for tax purposes. The Treasury Department and the IRS view the proposal to use NAICS 2-digit codes as

addressing this concern because the codes are revised through notice and comment rulemaking, and OMB has never revised the codes at the 2-digit level.

A few commenters noted that a recent report by the Treasury Inspector General for Tax Administration (TIGTA) determined that the NAICS codes are “unreliable for use to identify businesses that may be subject to excise tax reporting and payment.” Treasury Inspector General for Tax Administration, *The Affordable Care Act: An Improved Strategy is Needed to Ensure Accurate Reporting and Payment of the Medical Device Excise Tax 5* (Jul. 17, 2014). The Treasury Department and the IRS consider the situation addressed by the TIGTA report to be distinguishable from the use of the NAICS 2-digit codes to identify separate unrelated trades or businesses for purposes of section 512(a)(6). The TIGTA report addressed the IRS’s efforts to determine the population of taxpayers subject to the new medical device excise tax based on the NAICS 6-digit code a taxpayer had reported on Schedule K, “Other Information,” of Form 1120, “U.S. Corporation Income Tax Return” to identify the activity from which it derives the largest percentage of total receipts. TIGTA found that not every medical device manufacturer used the same NAICS 6-digit code to report the activity, such that reliance on one NAICS 6-digit code would not identify all businesses that may be subject to the tax. TIGTA also noted that the NAICS 6-digit code did not always signify a business that is engaged in taxable sales of medical devices. Here, an exempt organization will be reporting each of its separate unrelated trades or businesses using the more general NAICS 2-digit codes on Form 990–T, “Exempt Organization Business Income Tax Return,” for the purpose of ensuring compliance with section 512(a)(6). As previously discussed, the NAICS 2-digit code describes a broader sector of the economy, making it more likely that taxpayers engaged in similar activities that could be described in more than one NAICS 6-digit code will nonetheless report those activities as part of the same overall sector.

i. NAICS 2-Digit Codes

As discussed in section 1 of this preamble, Notice 2018–67 permitted reliance on NAICS 6-digit codes as a method of identifying separate trades or businesses and requested comments regarding whether use of less than six digits of the NAICS codes, either alone or in combination with one or more other methods, would appropriately

identify separate trades or businesses for purposes of achieving the objectives of section 512(a)(6). Nearly all the commenters making recommendations on the NAICS codes rejected the use of NAICS 6-digit codes. These commenters noted that using NAICS 6-digit codes would result in significant administrative burden because an exempt organization would have to determine which of over 1,000 NAICS 6-digit codes most accurately describes its trades or businesses. Commenters noted that many NAICS 6-digit codes may apply to more than one trade or business activity or that no NAICS 6-digit code may exist to accurately describe a trade or business activity. Additionally, these commenters argued that the use of NAICS 6-digit codes could potentially require an exempt organization to split what has traditionally been considered one unrelated trade or business activity into multiple trades or businesses.

Half of the commenters making recommendations on the NAICS codes suggested adoption of NAICS 2-digit codes, which would identify trades or businesses in 20 sectors. These commenters generally explained that use of NAICS 2-digit codes would result in broader, less subjective identification of trades or businesses that would naturally permit the aggregation of similar activities. Furthermore, one of these commenters stated that the use of fewer digits of the NAICS codes would minimize implementation costs and reduce the administrative burden on the IRS as well as exempt organizations. This commenter opined that the NAICS 2-digit codes are less likely to change over time than the NAICS codes with more digits because the specificity of the NAICS codes increases as digits are added. NAICS 3-digit codes, which one commenter recommended adopting, identify 99 subsectors. By contrast, NAICS 4-digit codes, which two commenters recommended adopting, identify 311 industry groups.

The Treasury Department and the IRS recognize that limitations exist in using NAICS as a method of identifying an exempt organization's separate unrelated trades or businesses. However, the Treasury Department and the IRS conclude that adopting the NAICS 2-digit codes will minimize those limitations and that NAICS 2-digit codes are less likely to change over time than NAICS codes with more digits. At the same time, adoption of NAICS 2-digit codes will not allow the offsetting of losses between the 20 sectors of unrelated trades or businesses. Additionally, under existing precedent, an organization must determine whether

an activity is an "unrelated trade or business" within the meaning of section 513 before it determines what NAICS 2-digit code describes that "separate" unrelated trade or business. An organization cannot use losses from an activity that consistently generates losses to offset income from a profitable trade or business unless the organization can show that the loss-producing activity is conducted with the requisite profit motive. *See Portland Golf Club v. Commissioner*, 497 U.S. 154, 164 (1990) (confirming that, "[a]lthough [section 162] does not expressly require that a 'trade or business' must be carried on with an intent to profit, this Court has ruled that a taxpayer's activities fall within the scope of [section] 162 only if an intent to profit has been shown" and citing *Groetzinger*, 480 U.S. at 35); *Losantiville Country Club v. Commissioner*, 906 F.3d 468, 473–75 (6th Cir. 2018) (demonstrating profit motive without reference to profitability by applying section 183 factors).

Furthermore, the Treasury Department and the IRS conclude that use of NAICS 2-digit codes results in broader identification of trades or businesses that will minimize implementation costs and will mitigate the administrative burden on exempt organizations and the IRS that would be imposed by more detailed NAICS codes. The use of NAICS 2-digit codes should also reduce any inequity that might result from a code system that was not specifically designed to describe the business activities of exempt organizations.

For these reasons, the proposed regulations generally provide that an exempt organization will identify each of its separate unrelated trades or businesses using the first two digits of the NAICS code that most accurately describes a trade or business. The Treasury Department and the IRS request comments on whether another method, or additional methods, of identifying an exempt organization's separate unrelated trades or businesses better achieves the intent of Congress in enacting section 512(a)(6) while still being administrable for exempt organizations and the IRS.

A few commenters requested confirmation that the Treasury Department and the IRS will permit an exempt organization to rely on the NAICS code that describes all the activities of the organization. For example, NAICS describes educational services, which includes colleges, universities, and professional schools, under one NAICS 2-digit code (61).

An unrelated trade or business generally is any trade or business the conduct of which is not substantially related to the exercise or performance by such exempt organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. *See* section 513(a). A NAICS code that describes all of an exempt organization's activities, even those activities that are substantially related to the exercise or performance of the exempt organization's exempt function, fails to identify the exempt organization's unrelated trades or businesses and undermines the Congressional intent in enacting section 512(a)(6). Accordingly, the proposed regulations clarify that the NAICS code chosen must identify the unrelated trade or business in which the exempt organization engages (directly or indirectly) and not the activities the conduct of which are substantially related to the exercise or performance by such exempt organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an exempt organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). Thus, returning to the previous example, a college or university cannot choose NAICS code 61 for all its unrelated trade or business activities.

Similarly, one commenter requested that the Treasury Department and the IRS confirm that a qualified retirement plan can use the NAICS code describing employee benefit funds, which is included under the NAICS 2-digit code for finance and insurance (52), to describe all the plan's unrelated trades or businesses. As discussed in the Background section, qualified retirement funds are subject to the general definition of UBTI in section 512(a)(1) but the term "unrelated trade or business" is defined in a special rule for trusts under section 513(b) as "any trade or business regularly carried on by such [plan] or by a partnership of which it is a member." Accordingly, it must use the NAICS 2-digit code that most accurately describes the underlying trade or business regularly carried on by the plan or by a partnership of which it is a member. However, it appears that qualified retirement plans generally derive most, if not all, of their UBTI from investment activities, the identification of which is discussed in section 2 of this preamble, and which includes UBTI from any qualifying partnership interests (see section 2.d of

this preamble) or qualifying S corporation interests (see section 4.a of this preamble). Accordingly, unless a qualified retirement plan engages directly in one or more unrelated trades or businesses or has non-qualifying partnership interests or non-qualifying S corporation interests, a qualified retirement plan will not be subject to section 512(a)(6) because it will only have one unrelated trade or business for purposes of section 512(a)(6)—its investment activities.

A social club described in section 501(c)(7) would not be able to use the NAICS 2-digit code for arts, entertainment, and recreation (71), which includes golf courses and country clubs, to identify all its unrelated trades or businesses. As explained in the Background section, social clubs are subject to the definition of UBTI in section 512(a)(3), which defines UBTI, in part, as “gross income (excluding exempt function income)” and does not refer directly to “any unrelated trade or business.” However, as further explained in section 5 of this preamble, these proposed regulations apply regardless of whether an organization is subject to the definition of UBTI in section 512(a)(1) or section 512(a)(3). Accordingly, a social club must use the NAICS code that most accurately describes its unrelated trade or business activities. The social club may use the NAICS 2-digit code for arts, entertainment, and recreation (71) only to the extent such code describes its unrelated trades or businesses, such as rounds of golf played by nonmembers, the greens fees for which would result in UBTI.

At least one commenter recommended that the proposed regulations permit an exempt organization to aggregate trades or businesses that may be described by multiple NAICS codes as a single trade or business when those activities are closely related, similar in nature, and essentially conducted as a single trade or business. Although the Treasury Department and the IRS recognize that the use of more digits of the NAICS codes could result in the division of business activities traditionally conducted as one unit into more than one trade or business, the use of NAICS codes at the 2-digit level, as noted by other commenters, results in the aggregation of trades or businesses in the same economic sector. Accordingly, the Treasury Department and the IRS address this comment by adopting the use of NAICS 2-digit codes.

ii. Codes Reported Only Once

The Treasury Department and the IRS recognize that an exempt organization can have a trade or business that it operates in different, geographic areas. For example, a hospital organization may operate several hospital facilities in a geographic area (or multiple geographic areas), all of which include pharmacies that sell goods to the general public. *See* Rev. Rul. 68–375, 1968–2 C.B. 245. Pharmacies are described under the NAICS 2-digit code for retail trade (44). Although each pharmacy potentially could be considered a “separate” trade or business under section 512(a)(6), particularly if separate books and records exist for each pharmacy, the Treasury Department and the IRS recognize that devising rules to distinguish between each pharmacy trade or business would introduce additional complexity and increase the administrative burden on the hospital organization. Accordingly, the proposed regulations provide that an exempt organization will report each NAICS 2-digit code only once. Thus, even though the hospital organization in the previous example operates more than one pharmacy, the hospital organization would report all the pharmacies using the NAICS 2-digit code for retail trade (44), along with any other retail trades or businesses described by this NAICS 2-digit code, on Form 990–T as one unrelated trade or business.

iii. Erroneous Codes

The proposed regulations provide that, once an exempt organization has identified a separate unrelated trade or business using a particular NAICS 2-digit code, the organization may not change the NAICS 2-digit code describing that trade or business unless the organization can show that the NAICS 2-digit code chosen was due to an unintentional error and that another NAICS 2-digit code more accurately describes the trade or business. This limitation will apply to codes reported on the first Form 990–T filed after final regulations under section 512(a)(6) are published in the **Federal Register**. The Treasury Department and the IRS anticipate that the instructions to the Form 990–T will be revised to describe how an exempt organization provides notification of such an error. Additionally, the Treasury Department and the IRS request comments regarding whether there are other circumstances in which an exempt organization should be permitted to change NAICS 2-digit codes.

b. New Identification Methods

At least two commenters suggested that the proposed regulations permit the Treasury Department and the IRS the flexibility to add new methods of identifying separate unrelated trades or businesses through guidance published in the Internal Revenue Bulletin. The Treasury Department and the IRS recognize that other code systems may exist (and have not yet been identified) or may be devised in the future that better reflect the unrelated trade or business activities engaged in by exempt organizations. However, the Treasury Department and the IRS also expect that the proposed regulations provide a method of identifying separate unrelated trades or businesses that is administrable for exempt organizations and the IRS and therefore do not anticipate the need to routinely modify that method. As more experience is gained over time with the administration of section 512(a)(6), the Treasury Department and the IRS may consider additional identification methods, including the use of code systems or indices other than NAICS, and will publish guidance as needed.

c. De Minimis Exceptions

One commenter recommended that the Treasury Department and the IRS adopt a de minimis exception for exempt organizations reporting less than \$100,000 of gross UBTI. Relying on statistical data published by the IRS, the commenter states that such organizations were responsible for only five percent of the total unrelated business income tax paid in 2013. This commenter argued that small exempt organizations likely lack the internal staff and the resources to implement the changes required by the enactment of section 512(a)(6) and to engage outside professionals to assist with ongoing compliance with that section.

As a result of the commenter’s proposed threshold, section 512(a)(6) would not apply to more than 80 percent of the exempt organizations filing Form 990-Ts (based on the statistical data cited by the commenter). *See* Table 4. Unrelated Business Income Tax Returns: Returns with Positive Unrelated Business Taxable Income: Number of Returns, Gross Unrelated Business Income (UBI), Total Deductions, Unrelated Business Taxable Income, and Total Tax, by Type of Entity and Size of Gross UBI Tax Year 2013, available at <https://www.irs.gov/statistics/soi-tax-stats-exempt-organizations-unrelated-business-income-ubi-tax-statistics#2>. Accordingly, a supposed “de minimis”

rule with a \$100,000 gross UBTI threshold would effectively render section 512(a)(6) a nullity for most exempt organizations.

More importantly, as noted by the commenter, section 512(a)(6) does not provide a de minimis rule and does not provide discretionary authority for the Treasury Department and the IRS to establish one. Accordingly, even at a lower threshold, a de minimis rule would be contrary to the stated Congressional intent of not permitting exempt organizations to use losses from one unrelated trade or business to offset the gains from another unrelated trade or business. However, the Treasury Department and the IRS note that the use of NAICS 2-digit codes, along with the treatment of an exempt organization's investment activities as one unrelated trade or business (as described in section 2.a of this preamble), is expected to address many of the concerns prompting the request for a de minimis rule because smaller entities are not as likely to have more than one unrelated trade or business. The Treasury Department and the IRS therefore do not adopt this comment.

d. Allocation of Directly Connected Deductions

i. In General

Section 512(a)(1) permits an exempt organization with an unrelated trade or business to reduce the income from that trade or business by the deductions allowed by chapter 1 that are directly connected with the carrying on of such trade or business. To be "directly connected" with a trade or business, an item of deduction must have a proximate and primary relationship to the carrying on of the unrelated trade or business generating the gross income. See § 1.512(a)-1(a). Expenses, depreciation, and similar items attributable solely to the conduct of an unrelated trade or business are proximately and primarily related to that trade or business and qualify to reduce income from such trade or business under section 512(a)(1) to the extent such items meet the requirements of sections 162 (trade or business expenses), 167 (depreciation), and other relevant provisions. To the extent that an exempt organization may have items of deduction that are shared between an exempt activity and an unrelated trade or business, § 1.512(a)-1(c) provides special rules for allocating such expenses. For example, if facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, then expenses, depreciation, and similar items

attributable to such facilities must be allocated between the two uses on a reasonable basis. See § 1.512(a)-1(c).³

The allocation issues under section 512(a)(1) are also relevant under section 512(a)(6) because an exempt organization with more than one unrelated trade or business must not only allocate indirect expenses among exempt and taxable activities as described in § 1.512(a)-1(c) but also among separate unrelated trades or businesses. Accordingly, Notice 2018-67 stated the Treasury Department and the IRS are considering modifying the underlying reasonable allocation method in § 1.512(a)-1(c) and providing specific standards for allocating expenses relating to dual use facilities and the rules under section 512(a)(6). Notice 2018-67 requested comments regarding possible rules or defined standards for the allocation of indirect expenses between separate unrelated trades or businesses for purposes of calculating UBTI under section 512(a)(6)(A), and regarding what allocation methods should be considered "reasonable."

The three commenters addressing allocation methods generally recommended retaining the current "any reasonable method" approach. Nonetheless, one of these commenters recommended that the Treasury Department and the IRS adopt existing cost allocation rules set forth by the OMB, referred to as the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (2 CFR 200), and by the Financial Accounting Standards Board in the Accounting Standard Update 2016-14, both of which require allocations to be made "on a rational, reasonable, and objective basis across functional expense categories." Another commenter recommended adopting accounting methods specific to social club activities, such as a golf.

The Treasury Department and the IRS are concerned that permitting allocation methods based solely on reasonableness is difficult for the IRS to administer and may not provide certainty for taxpayers. Whether an allocation method is "reasonable" depends on all the facts and circumstances. See *Rensselaer Polytechnic Institute v. Commissioner*,

³ The same method used for allocating expenses in determining taxable income must also be used when determining whether an activity is conducted with the intent to profit, and thus (as discussed further in section 5.b.iv of this preamble) whether such activity is a trade or business. *Portland Golf Club v. Commissioner*, 497 U.S. 154, 171 (1990) (stating that "in demonstrating the requisite profit motive, Portland Golf must employ the same method of allocating fixed expenses as it uses in calculating its actual loss").

79 T.C. 967 (1982), *aff'd* 732 F.2d 1058 (2d Cir. 1984) (finding an allocation method based on actual use to be "reasonable" within the meaning of § 1.512(a)-1(c)). The Treasury Department and the IRS continue to consider the allocation issue and intend to publish a separate notice of proposed rulemaking providing further guidance on this issue. Until publication of a separate notice of proposed rulemaking, these proposed regulations incorporate the existing allocation standard in § 1.512(a)-1(c), which provides that an exempt organization must allocate deductions on a reasonable basis between separate unrelated trades or businesses. The proposed regulations also provide that the use of the unadjusted gross-to-gross method is not a reasonable allocation method under the general allocation rule and as incorporated for section 512(a)(6) purposes (see section 1.d.iii of this preamble).

ii. State and Local Taxes and Tax Preparation Fees

At least one commenter requested guidance on the deduction of certain general expenses. This commenter recommended that tax return preparation fees be permitted as a deduction after calculation of total UBTI under section 512(a)(6)(B). The commenter argued that such expenses should not be allocated between separate unrelated trades or businesses because such expenses pertain to all the exempt organization's activities—related and unrelated.

As previously discussed, deductions are permitted under section 512(a)(1) and (3) only if two conditions are met: (1) The deduction is allowed under chapter 1; and (2) in the case of section 512(a)(1), the deduction is directly connected with the carrying on of such separate unrelated trade or business, or, in the case of section 512(a)(3), the deduction is directly connected with the production of the gross income (excluding exempt function income). Accordingly, an exempt organization may deduct only tax return preparation fees that are directly connected with a separate unrelated trade or business, in the case of an organization subject to section 512(a)(1), or that are directly connected with the production of the gross income (excluding exempt function income), in the case of an organization subject to section 512(a)(3). If such fees are directly connected with more than one separate unrelated trade or business or are also attributable to the exempt organization's related activities (or exempt function income in the case of an organization subject to section

512(a)(3)), the exempt organization must allocate such expenses as discussed in section 4.d.i of this preamble. See § 1.512(a)-1(c). Nothing in section 512(a)(6)(B) permits either the deduction of expenses that are not otherwise deductible in calculating UBTI or the deduction of expenses after calculation of total UBTI. Thus, the Treasury Department and the IRS do not adopt this comment.

One commenter also suggested that state income taxes not directly connected with any separate unrelated trade or business resulting from the increase in UBTI under section 512(a)(7) be permitted as a deduction after calculation of total UBTI under section 512(a)(6)(B). With the repeal of section 512(a)(7), the Treasury Department and the IRS expect that exempt organizations are no longer subject to state income taxes that are not directly connected with the carrying on of a separate unrelated trade or business. If this is not the case, the Treasury Department and the IRS request examples of such state income taxes.

iii. The Unadjusted Gross-to-Gross Method Is Unreasonable

The IRS has previously indicated that it will not litigate the reasonableness of the allocation method in *Rensselaer* pending revision of the Treasury regulations. 732 F.2d 1058, *action on dec.*, 1987-014 (Jun. 18, 1987). However, regarding facilities or personnel that are used both to carry on exempt activities and to conduct unrelated trade or business activities or more than one separate unrelated trade or business, the Treasury Department and the IRS have concluded that allocation of expenses, depreciation, and similar items using an unadjusted gross-to-gross method is not reasonable. In general, a gross-to-gross method of allocation uses a ratio of gross income from an unrelated trade or business activity over the total gross income from both unrelated and related activities generating the same indirect expenditures. The percentage resulting from this ratio is used to determine the percentage of the shared costs attributable to the unrelated trade or business activity (or activities).

In some circumstances, the provision of a good or service can be both related and unrelated depending on to whom the good or service is offered. For example, with respect to social clubs, the provision of goods and services to members is an exempt function whereas the provision of the same goods and services to nonmembers is a nonexempt function. Another example is a school that operates a ski facility for use in its

physical education program and for recreational use by its students and the general public. Rev. Rul. 78-98, 1978-1 C.B. 167. If the social club charges nonmembers a higher price than it charges members for the same good or service or if the school charges the general public more for slope and ski lift fees than it charges its students, the gross-to-gross ratio will increase, resulting in more indirect expenses being allocated to the unrelated activity. However, no difference likely exists in the cost of providing the good or service to members versus nonmembers or in the cost of providing the ski slopes and lifts to students versus the public. Accordingly, the failure to adjust the price of the good or service offered to nonmembers or the general public for purposes of determining the allocation of indirect expenses (that is, using an unadjusted gross-to-gross method) overstates the percentage of the indirect expenses that should be allocated to the unrelated activities. See *Portland Golf*, 497 U.S. at 157 fn. 4 (indicating that a system where the taxpayer “charges nonmembers higher prices for food and drink than members are charged, even though nonmembers’ meals presumably cost no more to prepare and serve” seems likely to “[overstate] the percentage of fixed costs properly attributable to nonmember sales”).

When an organization charges different prices for the same good or service depending on whether the offering of the good or service is a related or unrelated activity, then such organization should adjust the per “unit” price of the good or service of the related activity to that of the unrelated activity (or activities) for the ratio created by the gross-to-gross method to appropriately account for the percentage of indirect expenses attributable to the unrelated activity. Failing to make this adjustment does not appropriately account for the portion of indirect expenses attributable to an unrelated activity and is therefore an unreasonable method for allocating expenditures under § 1.512(a)-1(c). Accordingly, the proposed regulations provide that the unadjusted gross-to-gross method is not reasonable, whether under the general allocation rule or as incorporated for section 512(a)(6) purposes.

The Treasury Department and the IRS request comments regarding whether any other allocation methods should be considered unreasonable and the methods or rules that could be adopted instead of a reasonableness standard for allocations both between related and unrelated activities and between two or more separate unrelated trades or businesses.

2. Activities in the Nature of Investments

Several commenters expressed concern regarding the use of the NAICS codes to identify investment activities as one or more separate unrelated trades or businesses. One commenter noted that a partnership is not required to report the NAICS codes for all the trades or businesses in which it engages on the Schedule K-1 (Form 1065), “Partner’s Share of Income, Deductions, Credits, etc.,” provided to its partners. Another commenter expressed concern that the NAICS codes lacked specificity for purposes of sufficiently identifying an exempt organization’s investment activities. Therefore, two commenters suggested that an exempt organization’s investment activities be identified separately from other activities identified using the NAICS codes.

Consistent with Notice 2018-67, the proposed regulations generally permit the aggregation of the investment activities specifically listed in the proposed regulations for purposes of section 512(a)(6) to mitigate the burden on exempt organizations, particularly those with interests in multi-tier partnerships. However, under the proposed regulations, investment activities are not identified using NAICS 2-digit codes. Specifically, the proposed regulations provide that NAICS 2-digit codes are used to identify separate unrelated trades or businesses except to the extent provided in other paragraphs of the proposed regulations. Under the proposed regulations, an exempt organization’s investment activities, as well as the separate unrelated trades or businesses discussed in sections 3 and 4 of this preamble, are identified as described in the proposed regulations and reported as described in the forms and instructions (see section 8 of this preamble).

a. Investment Activities Are Treated as a Separate Unrelated Trade or Business for Purposes of Section 512(a)(6)

As a general matter, a number of commenters suggested that the Treasury Department and the IRS should not treat an exempt organization’s investment activities as an unrelated trade or business, and therefore the income and losses from these activities should not be considered for purposes of applying section 512(a)(6). The Treasury Department and the IRS have concluded that the structure and purposes of sections 511 through 514 indicate that an exempt organization’s investment activities should be treated as a separate unrelated trade or business for purposes of section 512(a)(6). Section 512(a)(1)

provides that UBTI means the gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it. Further, section 512(a)(1) provides that an exempt organization excludes from the calculation of UBTI the amounts described in section 512(b)(1), (2), (3), and (5)—that is, dividends, interest, annuities, etc.; royalties; rents; and capital gains. If an exempt organization's investment activities were not an unrelated trade or business, exclusion of certain amounts under section 512(b), such as capital gains (and losses) under section 512(b)(5), would appear to be unnecessary. Furthermore, other income that an exempt organization may consider "investment income"—such as unrelated debt-financed income—is treated as "derived from an unrelated trade or business" under other paragraphs of section 512(b)—including section 512(b)(4). The application of section 512(a)(6) to income included in UBTI under section 512(b)(4), (13), or (17) is discussed in more detail in section 3 of this preamble.

Some commenters cited *Higgins v. Commissioner*, 312 U.S. 212 (1941), to support the position that an exempt organization's investment of its own assets is not a trade or business. However, *Higgins* is not relevant under sections 511 through 514 because it applies to individuals, not corporations or trusts. For the taxable years involved in *Higgins*, a deduction was allowed for all ordinary and necessary expenses of carrying on a trade or business, but a deduction was not allowed for personal, living, or family expenses. Congress responded to *Higgins* by enacting what is now section 212(1) to allow individuals to deduct all ordinary and necessary expenses incurred in the production or collection of income. *Estate of Rockefeller v. Commissioner*, 762 F.2d 264, 266 n.3 (2d Cir. 1985). Section 212 applies only to individuals. Corporations or trusts may deduct only "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" under section 162. Thus, no deduction for expenses directly connected with investment activities would be permitted to a corporation or trust unless its investment activities are a part of a trade or business within the meaning of section 162.

However, the Treasury Department and the IRS recognize that exempt organizations have UBTI under sections 511 through 514 from activities engaged in with an intent to make an investment rather than with the intent to actively participate in any of the unrelated trade

or business activities generating the UBTI. Accordingly, Notice 2018–67 stated that, as a matter of administrative convenience, the proposed regulations would treat an exempt organization's investment activities as one trade or business for purposes of section 512(a)(6)(A) in order to permit the exempt organization to aggregate gross income and directly connected deductions from possibly multiple separate unrelated trades or businesses. After publication of Notice 2018–67, the Joint Committee on Taxation (JCT) confirmed that "it is intended that the Secretary consider whether it would be appropriate in certain cases to permit an organization that maintains an investment portfolio to treat multiple investment activities as one unrelated trade or business." Staff of the Joint Committee on Taxation, General Explanation of Public Law 115–97 (December 2018), at 293 (General Explanation). Consistent with Notice 2018–67 and the General Explanation, the proposed regulations provide that an exempt organization's various investment activities, as exclusively listed therein, are treated as a separate unrelated trade or business for purposes of section 512(a)(6)(A) and the proposed regulations.

b. Exclusive List of "Investment Activities"

Notice 2018–67 did not define the term "investment activities" but rather requested comments regarding the scope of the activities, both investment partnership interests or other investment activities, that should be included in the category of "investment activities" for purposes of section 512(a)(6). Some commenters suggested that the term "investment activities" include all passive income. Some of these commenters specifically suggested using the definition of "material participation" in section 469 as a method to identify "investment activities." However, most commenters addressing this issue suggested that the term "investment activities" should include activities that give rise to amounts included as: An item of gross income derived from an unrelated trade or business under section 512(b)(4) (debt-financed property), (13) (certain amounts received from controlled entities), and (17) (certain amounts derived from foreign corporations); gross income (or loss) from a partnership that is not directly or indirectly controlled by the exempt organization; and, with respect to controlled partnerships, an item of gross income derived from an unrelated trade

or business under section 512(b)(4), (13), and (17).

In drafting these proposed regulations, the Treasury Department and the IRS considered whether to provide a general definition of the term "investment activities." However, even though other areas of the Code make a distinction between "active" and "passive" activities, those distinctions are not applicable for purposes of sections 511 through 514. Section 512(c) applies regardless of whether the exempt organization is an active or passive participant in the unrelated trade or business of the partnership or whether it is a general or limited partner. Rev. Rul. 79–222; *Service Bolt & Nut Co. v. Commissioner*, 724 F.2d 519, 523–24 (6th Cir., 1983), *affg*, 78 T.C. 812 (1982); *see also Leila G. Newhall Unitrust v. Commissioner*, 105 F.3d 482 (9th Cir. 1997), *affg*, 104 T.C. 236 (1995) (following *Service Bolt & Nut*, 724 F.2d 519). Thus, the Treasury Department and the IRS do not believe that use of the criteria for finding "material participation" under section 469 is appropriate in applying section 512(a)(6).

Rather, the proposed regulations provide an exclusive list of an exempt organization's investment activities that can be treated as one separate unrelated trade or business for purposes of section 512(a)(6). Under the proposed regulations, for most exempt organizations, such investment activities are limited to: (i) Qualifying partnership interests (see section 2.d of this preamble); (ii) debt-financed properties (see section 3.a of this preamble); and (iii) qualifying S corporation interests (see section 4.a of this preamble). As discussed in section 5.b.i of this preamble, the qualifying partnership rules do not apply to social clubs described in section 501(c)(7). However, for exempt organizations subject to section 512(a)(3) (including social clubs), the proposed regulations clarify that UBTI from the investment activities of such organizations includes certain additional amounts (see section 5.a of this preamble).

The Treasury Department and the IRS will continue to consider whether the term "investment activities" can be defined more generally in a manner that is administrable and consistent with the legislative intent of section 512(a)(6). The Treasury Department and the IRS request comments regarding the specific factors that should be considered when determining whether an activity is an investment activity for purposes of section 512(a)(6).

c. Partnership Interests

With respect to partnership interests, the Treasury Department and the IRS stated in Notice 2018–67 that the category of “investment activities” for purposes of section 512(a)(6) should include only partnership interests in which the exempt organization does not significantly participate in any partnership trade or business. Some commenters suggested including in this category partnerships over which the exempt organization has no control, which is discussed in more detail in section 2.d of this preamble.

Other commenters suggested that this category include all limited partnerships or limited liability companies (LLCs) in which the exempt organization is a non-managing member (regardless of the exempt organization’s percentage interest or other participation in the partnership). The Treasury Department and the IRS decline to adopt this comment because of the variation in state law for determining non-managing member equivalent interests and the administrative burden that reliance on state law places on the IRS. Nonetheless, as discussed in section 2.d.iii.B of this preamble, the Treasury Department and the IRS recognize that there may be rights or actions permitted by state law that are normal and routine and that do not indicate any measurable influence or control over a partnership. Accordingly, the Treasury Department and the IRS request comments on whether certain permitted rights or actions should be disregarded in determining whether a partnership interest is a qualifying partnership interest. In addition, the proposed regulations clarify that any partnership in which an exempt organization is a general partner for any federal tax purpose is not a qualifying partnership interest within the meaning of the proposed regulations, regardless of the exempt organization’s percentage interest.

d. Qualifying Partnership Interests

Pending publication of proposed regulations, the interim rule described in Notice 2018–67 permitted an exempt organization to aggregate its UBTI from certain partnership interests with multiple trades or businesses, including trades or businesses conducted by lower-tier partnerships (qualifying partnership interest). See section 6.01(2) of Notice 2018–67. Additionally, the interim rule permitted the aggregation of any qualifying partnership interest (QPI) with all other QPIs, resulting in the treatment of the aggregate group of QPIs

as a single trade or business for purposes of section 512(a)(6)(A). *Id.*

Although some commenters suggested retaining the interim rule as described in Notice 2018–67, the majority of commenters appeared to support retention of the interim rule but made suggestions regarding possible revisions that potentially could reduce any administrative burden associated with the rule. Consistent with these comments, the proposed regulations retain the interim rule with the modifications described in the following sections of this preamble.

i. Designation of a QPI

Like Notice 2018–67, the proposed regulations permit, but do not require, an organization to aggregate its UBTI from QPIs. See section 6.01(2) of Notice 2018–67. However, the proposed regulations add that, once an organization designates a partnership interest as a QPI (in accordance with forms and instructions), it cannot thereafter identify the trades or businesses conducted by the partnership that are unrelated trades or businesses with respect to the organization using NAICS 2-digit codes unless and until the partnership interest is no longer a QPI. For example, if an organization has a partnership interest that is a QPI and the organization designates that partnership interest as a QPI on its Form 990–T, the organization cannot, in the next taxable year, identify the trades or businesses of the partnership that are unrelated trades or businesses with respect to the organization using NAICS 2-digit codes. However, if in a future taxable year, the organization’s partnership interest is no longer a QPI, then the organization would be required to identify the trades or business of the partnership that are unrelated trades or businesses with respect to the organization using NAICS 2-digit codes.

A partnership interest is a QPI if it meets the requirements of either the de minimis test (discussed in section 2.d.ii of this preamble) or the control test (discussed in section 2.d.iii of this preamble).

ii. The De Minimis Test

Both Notice 2018–67 and the proposed regulations provide that a partnership interest is a QPI that meets the requirements of the de minimis test if the exempt organization holds directly no more than 2 percent of the profits interest and no more than 2 percent of the capital interest. See section 6.02(1) of Notice 2018–67. As noted by several commenters, the 2 percent threshold for the de minimis

test is consistent with the de minimis test under section 4943, which provides that a private foundation does not have excess business holdings in any corporation in which it (together with certain related private foundations described in section 4946(a)(1)(H)) owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock. The Treasury Department and the IRS chose not to cross-reference the section 4943 de minimis test because that section applies only to private foundations. Nonetheless, because Congress adopted a 2 percent de minimis test under section 4943, the Treasury Department and the IRS consider a 2 percent threshold to be appropriate for purposes of the de minimis test in the proposed regulations.

However, the proposed regulations make two changes to the de minimis test provided in Notice 2018–67 to improve administrability and to provide more appropriate relief. First, as discussed in section 2.d.iv of this preamble, an exempt organization is no longer required to combine certain related interests when determining whether a partnership interest meets the requirements of the de minimis test. Second, in response to comments that the interim rule should apply to lower-tier partnerships, the proposed regulations provide that, if an exempt organization does not control a partnership in which the exempt organization holds a direct interest (directly-held partnership interest) but that directly-held partnership interest is not a QPI because the exempt organization holds more than 20 percent of the capital interest, any partnership in which the exempt organization holds an indirect interest through the directly-held partnership interest (indirectly-held partnership interest) may be a QPI if the indirectly-held partnership interest meets the requirements of the de minimis test (look-through rule). Accordingly, the proposed regulations permit (but do not require) an exempt organization to aggregate the UBTI from some indirectly-held QPIs with its directly-held QPIs. However, the look-through rule does not apply to indirectly-held QPIs that do not meet the requirements of the de minimis test but may meet the requirements of the control test.

For example, if an exempt organization directly holds 50 percent of the capital interests of a partnership that it does not control and the directly-held partnership holds 4 percent of the capital and profits interests of lower-tier partnership A and 10 percent of the

capital and profits interests of lower-tier partnership B, the exempt organization can aggregate its interest in lower-tier partnership A with its other QPIs because the exempt organization indirectly holds 2 percent of the capital and profits interests of lower-tier partnership A (4 percent \times 50 percent = 2 percent). However, the exempt organization may not aggregate its interest in lower-tier partnership B with its QPIs because the exempt organization indirectly holds 5 percent (10 percent \times 50 percent) of the capital and profits interest of lower-tier partnership B, which does not meet the requirements of the de minimis test.

If a directly-held partnership interest is not a QPI, the general principles of section 512(c) apply and the exempt organization is required to identify the trades or businesses conducted by the directly-held partnership, and any indirectly-held partnerships, that are unrelated trades or businesses with respect to the exempt organization. The Treasury Department and the IRS expect that permitting an exempt organization to aggregate any indirectly-held partnership interests that meet the requirements of the de minimis test with all other QPIs will reduce the administrative burden on exempt organizations because there will be no need to identify each trade or business conducted by such indirectly-held partnership. However, the Treasury Department and the IRS request comments regarding the administrability of permitting the aggregation of indirectly-held partnership interests that meet the requirements of the de minimis test.

iii. The Control Test

Notice 2018–67 stated that a partnership interest is a QPI that meets the requirements of the control test if the exempt organization (i) directly holds no more than 20 percent of the capital interest; and (ii) does not have control or influence over the partnership. See section 6.03(1) of Notice 2018–67.

A. Percentage Interest

Numerous commenters made recommendations regarding the first prong of the control test, most of which recommend increasing the percentage threshold to 50 percent to conform with the definition of control in section 512(b)(13). Multiple commenters suggested that the percentage control requirement be eliminated entirely.

The proposed regulations retain the 20 percent threshold used in Notice 2018–67. The Treasury Department and the IRS intend the percentage threshold

to be a proxy to identify partnership interests in which the exempt organization does not significantly participate in any partnership trade or business and therefore may appropriately be considered an investment activity for purposes of section 512(a)(6). The 20 percent threshold is consistent with at least one other administrative exception created for certain investment activities. See section 731(c)(3)(C)(i) & § 1.731–2(e). Accordingly, the proposed regulations treat a 20 percent interest in a partnership over which the exempt organization partner has no control (see section 2.d.iii.B of this preamble) as a part of the exempt organization's investment activities. However, as with the de minimis test, an exempt organization is no longer required to combine certain related interests when determining whether a partnership interest meets the 20 percent threshold under the control test (see section 2.d.iv of this preamble).

The Treasury Department and the IRS recognize that an exempt organization may have more than 20 percent of the capital interests of a partnership but the exempt organization may consider that partnership interest to be part of its investment activities raising funds for its exempt activities. However, as discussed in section 2.b of this preamble, the proposed regulations do not provide a general definition of the term “investment activities” such that a non-QPI could be aggregated with the exempt organization's other investment activities for purposes of section 512(a)(6). While the addition of the look-through rule to the de minimis test in these proposed regulations may result in the aggregation of some of the lower-tier partnership interests of a directly-held non-QPI, an exempt organization's investment intent is not sufficient to treat the overall non-QPI as part of its investment activities.

At least two commenters suggested that the capital interests in a partnership do not indicate control over a partnership. The Treasury Department and the IRS understand that a partner's percentage interest in the capital interests of a partnership does not necessarily correlate with the partner's ability to control the partnership. However, the Treasury Department and the IRS have concluded that a combination of an exempt organization's percentage capital interest in a partnership and the exempt organization's ability to control the partnership are an appropriate administrative proxy for determining whether a partnership interest is an investment activity. The use of a

percentage interest, in addition to the definition of “control” discussed in section 2.d.iii.B of this preamble, provides a bright line for the evaluation of partnership interests that may be investment activities. Furthermore, because an exempt organization's percentage profits interest may change throughout the year, the proposed regulations continue to consider only an exempt organization's capital interest in a partnership for purposes of the control test.

B. Definition of “Control”

Notice 2018–67 provided that all facts and circumstances are relevant for determining whether an exempt organization has control or influence over a partnership. See section 6.03(3) of Notice 2018–67. Notice 2018–67 then provided three specific circumstances in which an exempt organization has control or influence. *Id.* Commenters generally appeared to support the inclusion of a facts and circumstances test. Nonetheless, numerous commenters suggested revisions to what it means for an exempt organization to have influence or control over a partnership.

First, Notice 2018–67 provided that an exempt organization has control or influence if the exempt organization may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership. Several commenters recommended that the proposed regulations clarify that the right to vote for the appointment or removal of a general partner or managing member, the ability to appoint representatives to investor committees or advisory committees, and the right to approve the selection or removal of a general partner or managing member do not evidence influence or control. These commenters explained that these rights help ensure that the general partner cannot alter a partnership without the consent of the limited partners. Similarly, other commenters requested that the proposed regulations clarify that an exempt organization will not be deemed to have influence or control over a partnership if it exercises its rights or takes actions that it is permitted to take under state law while maintaining its limited liability status in a partnership.

Second, Notice 2018–67 provided that an exempt organization has control or influence over a partnership if any of the exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time, or if

the exempt organization has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees. One commenter stated that the presence of these rights or powers does not necessarily illustrate control. Another commenter suggested that this rule is overly restrictive and will cause many partnership interests in which an exempt organization has no influence or control to fail to meet the requirements of the control test. This commenter stated that many exempt organizations have governing board members that also work in the investment management industry and may participate in conducting the business of a partnership in which the exempt organization invests. The commenter explained that these individuals' expertise in financial management is essential for the prudent management of an exempt organization's investments. The commenter argued that a general rule based on facts and circumstances is sufficient to address situations in which an exempt organization exercises "excessive" influence or control over a partnership such that it should not be considered a QPI.

The proposed regulations retain the control rule described in Notice 2018–67 with minor modifications to address the comments described above. In particular, the proposed regulations remove the term "influence" so that the second prong of the control test provides that, if the exempt organization has 20 percent or less of the capital interests, a partnership interest is a QPI that meets the requirements of the control test if the exempt organization does not control the partnership. Consistent with Notice 2018–67, the proposed regulations provide that all the facts and circumstances are relevant for determining whether an exempt organization controls a partnership. The proposed regulations clarify that the partnership agreement is among the facts and circumstances that may be considered when making a determination of control.

The proposed regulations also list certain specific circumstances that evidence control, focusing on four discrete rights or powers. Two circumstances focus on the exempt organization's ability to perform certain actions on its own. Specifically, the proposed regulations provide that an exempt organization controls a partnership if 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 or has the power to appoint

or remove any of the partnership's officers or employees or a majority of directors. The remaining two circumstances focus on whether any of the exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time or to conduct the partnership's business at any time. No exception is provided for certain professionals that may serve on the boards of both the exempt organization and partnerships in which the exempt organization is a partner.

The Treasury Department and the IRS recognize that, although these rights or powers indicate control in some situations, other facts and circumstances may tip the scale the other way. Accordingly, the Treasury Department and the IRS request comments regarding whether all these rights or powers should be weighted the same or whether there are certain circumstances in which such right or power would never indicate control.

iv. Combining Related Interests

Both the de minimis test and the control test in Notice 2018–67 required an exempt organization to own less than a certain percentage of the profits and capital interests in a partnership. See sections 6.02(1) (de minimis test) and 6.03(1) (control test) of Notice 2018–67. In determining the exempt organization's ownership percentage, both the de minimis test and the control test required the exempt organization to combine certain related interests (aggregation rule). *Id.* The aggregation rule in section 6.02(2)(b)(i) of Notice 2018–67 provided that, when determining an exempt organization's percentage partnership interest, the interest of a disqualified person (as defined in section 4958(f)), a supporting organization (as defined in section 509(a)(3)), or a controlled entity (as defined in section 512(b)(13)) in the same partnership would be taken into account. See section 6.02(2)(b)(ii) through (iv) of Notice 2018–67.

Most commenters suggested that the aggregation rule is overly burdensome and requested that it be removed. Commenters noted that many public charity boards have numerous members and argued that verifying the board members' ownership percentages, after taking into account other related interests, for every partnership interest that generates UBTI would be unreasonable, if not impossible. Additionally, these commenters stated that the exempt organization cannot usually obtain information about other partners from the partnerships in which

it holds interests because of confidentiality agreements.

If the aggregation rule is retained, commenters recommended several revisions. First, two commenters suggested eliminating the aggregation rule for the de minimis test. Next, a commenter suggested only requiring aggregation of interests owned by controlled entities and persons with direct control over the exempt organization's investment decisions. Additionally, another commenter would limit aggregation with interests owned by controlled entities to those interests owned by Type I and II supporting organizations described in section 509(a)(3)(B)(i) and (ii) and exclude interests owned by Type III supporting organizations described in section 509(a)(3)(B)(iii). Finally, another commenter suggested requiring aggregation with interests owned by controlled entities but not interests owned by persons or organizations that are not controlled by the exempt organization.

The proposed regulations retain a modified aggregation rule to address situations in which an exempt organization may control a partnership through the aggregation of interests. The aggregation rule in the proposed regulations differs from the aggregation rule in Notice 2018–67 in two ways. First, the aggregation rule in the proposed regulations applies only for purposes of the control test and not for purposes of the de minimis test. Second, the proposed regulations do not require an exempt organization to take into account the interests of disqualified persons when determining the exempt organization's percentage interest in a partnership for purposes of the control test.

The proposed regulations adopt other aspects of the aggregation rule from Notice 2018–67 without change. In particular, the proposed regulations include the definitions of "supporting organization" and "controlled entity" used in Notice 2018–67, which cross-referenced sections 509(a)(3) and 512(b)(13)(D), respectively. Additionally, the proposed regulations provide that, when determining an exempt organization's percentage interest in a partnership for purposes of the control test, the interests of a supporting organization or a controlled entity in the same partnership will be taken into account. However, the Treasury Department and the IRS will continue to consider whether the aggregation of the interests of supporting organizations is appropriate in the circumstance in which the exempt organization is a supported

organization that has little to no control over its supporting organizations.

v. Reliance on Schedule K–1 (Form 1065)

Notice 2018–67 provided that, in determining the exempt organization's percentage interest in a partnership, the exempt organization may rely on the Schedule K–1 (Form 1065) (or its successor) it receives from the partnership. Commenters requested various revisions to the Schedule K–1 (Form 1065) to assist in the reporting process. The Treasury Department and the IRS will consider revisions to the Schedule K–1 (Form 1065). Otherwise, the proposed regulations continue to permit reliance on Schedule K–1 (Form 1065) if the form lists the exempt organization's percentage profits interest or its percentage capital interest, or both, at the beginning and end of the year. However, the proposed regulations clarify that the exempt organization may not rely on the form to the extent that any information about the exempt organization's percentage interest is not specifically provided. For example, if the Schedule K–1 (Form 1065) an exempt organization receives from a partnership lists the exempt organization's percentage capital interest at the beginning and end of the year but lists its profits interest as "variable," the exempt organization may rely on the form only with respect to its percentage capital interest.

vi. Additional Recommended Changes

Commenters suggested additional modifications to the de minimis and control tests, including phase-in and grace periods to address changes in an exempt organization's percentage interest that are beyond the exempt organization's control. Two commenters requested that an exempt organization be permitted up to 90 days to reduce its interest in a partnership in order to satisfy the requirements of the de minimis test if the increase in interest was because of another partner's withdrawal or percentage reduction. Another commenter suggested that, if a partnership interest met the requirements of either the de minimis test or the control test in a taxable year, the partnership interest should continue to meet those requirements in the following taxable years if the exempt organization's percentage interest changed through no action of the exempt organization partner.

The proposed regulations do not adopt any of these recommended changes because the de minimis and control tests are rules of administrative convenience. Allowing greater interests

due to other actions would require other safeguards and limitations that would complicate the rule and place additional administrative burdens on exempt organizations and the IRS. Nevertheless, the Treasury Department and the IRS recognize that an exempt organization may not be aware of changes in its partnership interest until it receives a Schedule K–1 (Form 1065) from the partnership at the end of the partnership's taxable year. In such a circumstance, it may be appropriate to permit a higher percentage interest in taxable years in which the increase in an exempt organization's percentage interest during a taxable year is the result of the actions of other partners. Accordingly, the Treasury Department and the IRS request comments regarding whether permitting a higher percentage interest in taxable years in which the increase occurs as the result of the actions of other partners would address these commenters' concerns.

e. Transition Rule

Pending publication of proposed regulations, the transition rule in Notice 2018–67 permitted an exempt organization to treat each partnership interest acquired prior to August 21, 2018, that failed to meet the requirements of either the de minimis test or the control test as one trade or business for purposes of section 512(a)(6), regardless of whether there was more than one trade or business directly or indirectly conducted by the partnership or lower-tier partnerships. See section 6.04 of Notice 2018–67.

Many commenters asserted that the transition rule should apply to any partnership interest held by an exempt organization regardless of the date acquired. However, in the case of a partnership that conducts more than one trade or business that is a separate unrelated trade or business with respect to the exempt organization, applying the transition rule to all partnership interests and treating each non-QPI as one trade or business would undermine the purpose of section 512(a)(6) by allowing the gains from one unrelated trade or business to offset the losses from another unrelated trade or business. Accordingly, the Treasury Department and the IRS do not accept this comment.

Other commenters suggested that the proposed regulations should clarify that, if an exempt organization acquired a partnership interest before August 21, 2018, changes in the exempt organization's percentage interest would not affect the availability of the transition rule. Accordingly, the proposed regulations clarify that a

partnership interest acquired prior to August 21, 2018, will continue to meet the requirement of the transition rule even if the exempt organization's percentage interest changes on or after August 21, 2018.

The proposed regulations also include two additions to the transition rule. First, the proposed regulations permit an exempt organization to rely on the transition rule only until the first day of the organization's first taxable year beginning after the date these proposed regulations are published as final regulations (transition period). Second, the proposed regulations provide that 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. During the transition period, the exempt organization must determine how a partnership interest to which it chose to apply the transition rule will be treated under the final regulations. The Treasury Department and the IRS request comments regarding whether any additional transitional relief is necessary.

3. Inclusions of Income Derived From an Unrelated Trade or Business Under Section 512(b)(4), (13), and (17)

Section 512(b)(4), (13), and (17) require the inclusion of certain income as items of gross income derived from an unrelated trade or business if such income is unrelated debt-financed income, a specified payment from controlled entities, or certain insurance income derived from a controlled foreign corporation, respectively. In Notice 2018–67, the Treasury Department and the IRS explained that, in the absence of section 512(b)(1), (2), (3), and (5), the income described in these sections would be included in the calculation of UBTI to the extent that such amounts are "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it" under section 512(a)(1). Accordingly, the Treasury Department and the IRS stated that no distinction existed between "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it" within the meaning of section 512(a)(1) and amounts included "as an item of gross income derived from an unrelated trade or business" under section 512(b)(4), (13), and (17).

However, the Treasury Department and the IRS recognized that some interpretations of section 512(a)(6) might impose a significant burden on exempt organizations required to include certain income in UBTI under section 512(b)(4), (13), or (17), and,

consequently, that aggregating income included in UBTI under these sections may be appropriate in certain circumstances. In Notice 2018–67, the Treasury Department and the IRS requested comments regarding the treatment under section 512(a)(6) of income that is not from a partnership, but that is included in UBTI under section 512(b)(4), (13), and (17).

A few commenters disagreed with the statement that there is “no distinction between ‘gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it’ under section 512(a)(1) and amounts included in UBTI ‘as an item of gross income derived from an unrelated trade or business’ under section 512(b)(4), (13), and (17).” These commenters argued that amounts included as items of gross income from an unrelated trade or business under section 512(b)(4), (13), and (17) should not be subject to section 512(a)(6) because such amounts are treated as income from investment activities and not as gross income from a trade or business.

As discussed in section 2.a of this preamble, investment activities are treated as a separate unrelated trade or business for purposes of section 512(a)(6). Furthermore, section 512(b)(4), (13), and (17) each provide that income described in the provision is income derived from an unrelated trade or business. Accordingly, amounts included in UBTI under section 512(b)(4), (13), and (17) contribute to the determination of whether an organization has more than one unrelated trade or business and thus is subject to section 512(a)(6). After considering the comments received and the legislative history of each section, the Treasury Department and the IRS propose the following treatment of amounts included in UBTI under section 512(b)(4), (13), and (17) for purposes of section 512(a)(6).

a. Unrelated Debt-Financed Income

In the case of debt-financed property (as defined in section 514), section 512(b)(4) requires an exempt organization to include, as an item of gross income from an unrelated trade or business, any unrelated debt-financed income, determined under section 514, with respect to such debt-financed property, even if an amount received with respect to the debt-financed property would ordinarily be excluded from the calculation of UBTI under section 512(b)(1), (2), (3), or (5). Section 514(b)(1) defines the term “debt-financed property” as any property that is held to produce income and with respect to which there is acquisition

indebtedness. Section 1.514(b)–1(a) clarifies that property held to produce income includes rental real estate, tangible personal property, and corporate stock. Section 1.514(a)–1(a) provides that the calculation of debt-financed taxable income is made on a property-by-property basis. Thus, as stated in Notice 2018–67, one interpretation of sections 512(b)(4) and 514 and the regulations thereunder could require each debt-financed property to be treated as a separate unrelated trade or business under section 512(a)(6).

However, the amounts excluded from the calculation of UBTI under section 512(b)(1), (2), (3), and (5) that are included in UBTI if subject to acquisition indebtedness include dividends, interest, annuities, royalties, rents, and capital gains. As acknowledged in section 2.a of this preamble, dividends, interest, annuities, royalties, rents, and capital gains generally are income from investment activities. Additionally, section 514 generally does not apply to any property to the extent that the income from such property is taken into account in computing the gross income of any unrelated trade or business (except in the case of capital gains from such property that would be excluded under section 512(b)(5)). See section 514(b)(1)(B). Accordingly, the Treasury Department and the IRS agree with commenters that debt-financed properties (as defined in section 514) generally are held for investment purposes. Therefore, to reduce the reporting burden on exempt organizations, the proposed regulations include all the UBTI under section 512(b)(4) from an exempt organization’s debt-financed property or properties (and not just its unrelated debt-financed income arising in connection with a QPI as provided in Notice 2018–67) in the list of “investment activities” treated as a separate unrelated trade or business for purposes of section 512(a)(6).

The Treasury Department and the IRS note that rental of certain property is a trade or business that must be identified using NAICS 2-digit codes. For example, section 512(b)(3)(B) provides that rents from real and personal property are included in UBTI if more than 50 percent of the total rent received or accrued under a lease is attributable to personal property. Also, § 1.512(b)–1(c)(5) indicates that payments for the use or occupancy of rooms or other space where services are also rendered to the occupant do not constitute rent from real property. Sections 512(b)(4) and 514 do not apply where such real or personal property is purchased with

debt financing because the rents from these properties will have already been included in UBTI. See section 514(b)(1)(B) (providing that, except in the case of income excluded under section 512(b)(5), the term “debt-financed property” does not include any property to the extent that the income from such property is taken into account in computing the gross income of any unrelated trade or business); § 1.514(b)–1(b)(2)(i). Accordingly, because rent from such real and personal property is included in UBTI, the exempt organization must identify such unrelated trade or business using the NAICS 2-digit code for real estate rental and leasing (53).

b. Specified Payments Received From Controlled Entities

Notwithstanding section 512(b)(1), (2), and (3), section 512(b)(13)(A) requires an exempt organization, referred to as a “controlling organization,” that receives or accrues (directly or indirectly) a specified payment from another entity which it controls, referred to as a “controlled entity,” to include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). See § 1.512(b)–1(l)(1). Section 512(b)(13)(C) defines the term “specified payment” as any interest, annuity, royalty, or rent. Accordingly, section 512(b)(13) treats certain amounts that would ordinarily be excluded from the calculation of UBTI under section 512(b)(1), (2), and (3) as income derived from an unrelated trade or business.

Commenters argued that amounts included in UBTI under section 512(b)(13) should be included with an exempt organization’s other investment activities. Presumably, this argument rests on the premise that the types of payments described in section 512(b)(13)(C)—that is, any interest, annuity, royalty, or rent—might be characterized generally as “investment income.” However, treating specified payments included in UBTI as income from an exempt organization’s investment activities would be inconsistent with the purpose of section 512(b)(13)(A), which is to prevent a controlled entity from gaining a competitive advantage (in contravention of the purposes of section 512) through making deductible payments to a controlling organization that is exempt from tax. See S. Rep. No. 91–552, at 73 (1969) (explaining that certain “rental” arrangements between exempt organizations and taxable subsidiaries

“enable[] the taxable [subsidiary] to escape nearly all of its income taxes”). Consistent with that purpose, section 512(b)(13)(A) treats a specified payment as income from an unrelated trade or business only “to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity).” Section 512(b)(13) thus views such payments as stemming from the trade or business activity of the controlled entity rather than from the “investment activity” of the controlling organization.

Further, the required degree of control of the controlling organization over the controlled entity indicates that the controlled entities are not a part of the controlling organization’s otherwise appropriately characterized investment activities. In general, section 512(b)(13)(D) defines the term “control” as ownership of more than 50 percent of the stock in a corporation, of the profits interests or capital interests in a partnership, or, in any other case, of the beneficial interests in an entity. The section 318 constructive ownership rules apply when determining the ownership of stock in a corporation, and similar principles apply in determining the ownership of interests in other types of entities. As generally discussed in section 2.d.iii.B of this preamble, control over an organization suggests that such interest is not part of the exempt organization’s investment activities. Accordingly, even though the controlled entity’s trades or businesses might not be attributed to the controlling organization (such as in the case of a controlled corporation), the control itself indicates that the controlled entity is held as part of a trade or business other than the controlling organization’s investment activities.

The plain language of section 512(b)(13) could require each specified payment to be treated as a separate unrelated trade or business under section 512(a)(6) because section 512(b)(13) requires an exempt organization to include such payment as an item of gross income derived from “an” unrelated trade or business. However, this treatment may impose a considerable administrative burden on controlling organizations that receive numerous specified payments from controlled entities, such as may be the case with a university or hospital system. Therefore, these proposed regulations permit an exempt organization to aggregate all the specified payments received from a controlled entity and to treat the payments as received from a single

separate unrelated trade or business for purposes of section 512(a)(6).

In particular, the proposed regulations provide that, if an exempt organization controls another entity (within the meaning of section 512(b)(13)(D)), the specified payments from that controlled entity will be treated as gross income from a separate unrelated trade or business for purposes of section 512(a)(6). If a controlling organization receives specified payments from two different controlled entities, the payments from each controlled entity are treated as separate unrelated trades or businesses. For example, a controlling organization that receives rental payments from two controlled entities will have two separate unrelated trades or businesses, one for each controlled entity. The specified payments from a controlled entity will be treated as gross income from one unrelated trade or business regardless of whether the controlled entity engages in more than one unrelated trade or business or whether the controlling organization receives more than one type of specified payment from that controlled entity.

c. Certain Amounts Derived From Foreign Corporations

Section 512(b)(17) requires any amount included in gross income under section 951(a)(1)(A) to be included as an item of gross income derived from an unrelated trade or business to the extent the amount so included is attributable to insurance income (as defined in section 953) which, if derived directly by the exempt organization, would be treated as an unrelated trade or business. Section 953(a)(1) defines “insurance income” as any income that (A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and (B) would (subject to certain modifications not relevant here) be taxed under subchapter L of chapter 1 if such income were the income of a domestic insurance company. Thus, section 512(b)(17) “applies a look-through rule in characterizing certain subpart F insurance income for unrelated business income tax purposes.” H.R. Rep. No. 104–586 (1996), at 137.

Commenters have argued that insurance income included in UBTI under section 512(b)(17) belongs in the category of investment activities. However, like section 512(b)(13), the required degree of control of the exempt organization over the controlled foreign corporation indicates that the exempt organization’s interest in a controlled foreign corporation probably is not a part of the exempt organization’s

otherwise appropriately characterized investment activities. In particular, section 951(a)(1)(A) applies only if a foreign corporation is a controlled foreign corporation, which section 957 defines as any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of the stock of such corporation is owned, directly, indirectly, or constructively by United States shareholders. Section 951(b) defines “United States shareholder,” with respect to any foreign corporation, as a United States person (within the meaning of section 7701(a)(30), which includes domestic corporations and certain trusts) who owns, directly, indirectly, or constructively, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.

Furthermore, insurance income included in UBTI under section 512(b)(17) should not be treated as gross income from an exempt organization’s investment activities because the provision of insurance generally is an unrelated trade or business. Section 501(m) provides that, in the case of an exempt organization described in section 501(c)(3) or (4) that does not provide commercial-type insurance as a substantial part of its activities, the activity of providing commercial-type insurance is treated as an unrelated trade or business (as defined in section 513). However, rather than treating insurance income from each controlled foreign corporation as income from a separate unrelated trade or business, these proposed regulations treat the provision of insurance by all controlled foreign corporations as one trade or business, regardless of whether such insurance income is received from more than one controlled foreign corporation. This approach is consistent with how NAICS would categorize the provision of insurance (52—Finance and Insurance).

However, the proposed regulations do not permit the aggregation of an exempt organization’s insurance income included in UBTI under section 512(b)(17) with any insubstantial commercial-type insurance activities conducted directly by the exempt organization because the controlled foreign corporation, not the exempt organization, is engaged in the activity giving rise to the insurance income included in UBTI under section 512(b)(17). The insurance activity is not attributed to the exempt organization

and thus is distinguishable from any commercial-type insurance activity engaged in directly by the exempt organization.

4. S Corporation Interest Treated as an Interest in an Unrelated Trade or Business

An S corporation is a “small corporation” that may elect to be treated under a simplified tax regime that acts as a hybrid between the rules for corporations and the rules for pass-through entities. In general, the items of income and loss of an S corporation are taxed directly to the shareholders of that corporation. See section 1366(a). The types of exempt organizations that are permitted to be shareholders of an S corporation are described in section 1361(c)(2)(A)(vi) and (6). Exempt organizations permitted to be S corporation shareholders include qualified retirement plans, exempt organizations described in section 501(c)(3), and certain IRAs (including, subject to the limitation described more specifically in 1361(c)(2)(A)(vi), an IRA designated as a Roth IRA under section 408A).

For purposes of the unrelated business income tax, section 512(e) provides special rules applicable to S corporations. Section 512(e)(1)(A) provides that, if an exempt organization permitted to be an S corporation shareholder holds stock in an S corporation, such interest will be treated as an interest in an unrelated trade or business. Thus, notwithstanding any other provision in sections 511 through 514, section 512(e)(1)(B) requires an exempt organization permitted to hold S corporation stock to take the following amounts into account in computing the UBTI of such exempt organization: (i) All items of income, loss, or deduction taken into account under section 1366(a) (regarding the determination of an S corporation shareholder’s tax liability); and (ii) any gain or loss on the disposition of the stock in the S corporation.

Notice 2018–67 did not address, or request comments on, the treatment of amounts taken into account in computing UBTI under section 512(e). Nonetheless, one commenter recommended that UBTI from an S corporation should be treated as income from a single trade or business regardless of the manner in which such income is earned by the S corporation. The commenter stated that having to separate all the income producing activities of an S corporation would be extremely burdensome. Accordingly, the commenter recommended that all income from an S corporation should be

aggregated with the income from QPIs to ensure similar treatment of all pass-through entities. In the alternative, the commenter suggested combining all income from S corporations in which the exempt organization shareholder owns less than 50 percent of the shares with the income from QPIs.

The proposed regulations generally provide that each S corporation interest will be treated as an interest in a separate unrelated trade or business, which is consistent with the language of section 512(e)(1)(A). Accordingly, if an exempt organization has two S corporation interests (that are not qualifying S corporation interests described in section 4.a of this preamble), the exempt organization will report two trades or businesses, one for each S corporation interest. The treatment of each S corporation interest as one trade or business for purposes of section 512(a)(6) is similar to the treatment of specified payments from a controlled entity under section 512(b)(13). Furthermore, the Treasury Department and the IRS view this treatment as best serving the purposes of section 512(a)(6).

Section 512(e) provides two different rules: One for items of income, loss, or deduction taken into account under section 1366(a) and one for any gain or loss on the disposition of S corporation stock. Although these amounts could be treated as separate unrelated trades or businesses for purposes of section 512(a)(6) due to the disparate methods of inclusion in the language of section 512(e), such treatment would artificially divide each S corporation interest into two trades or businesses. The separate enumeration of the gain or loss on the disposition of S corporation stock serves to override section 512(b)(5), which would otherwise exclude such gain or loss from the calculation of UBTI, and not to indicate the existence of a separate unrelated trade or business. Accordingly, the proposed regulations provide that the UBTI from an S corporation interest is the amount described in section 512(e)(1)(B), which includes both the items of income, loss, or deduction taken into account under section 1366(a) and the gain and loss on the disposition of S corporation stock.

a. Qualifying S Corporation Interests

Notwithstanding the general rule that each S corporation interest is treated as a separate unrelated trade or business, the Treasury Department and the IRS recognize that an exempt organization may hold S corporation stock for different purposes, including investment purposes. Additionally, the look-through treatment of an S

corporation is similar to the look-through treatment of a partnership. As discussed in section 2.d of this preamble, these proposed regulations permit the aggregation of QPIs to mitigate the burden on exempt organizations with interests in multi-tier partnerships. Similarly, the proposed regulations permit an exempt organization to aggregate its UBTI from an S corporation interest with its UBTI from other investment activities if the exempt organization’s stock ownership (by percentage of stock ownership) in the S corporation meets the requirements provided in the de minimis test or the control test for “qualifying partnership interests.” As such, if an exempt organization owns (by percentage of stock ownership) 2 percent or less of the stock in an S Corporation, or, if it owns 20 percent or less of the stock in such S corporation and meets the facts and circumstances requirements under the second prong of the control test, then such S corporation interest will be a “qualifying S corporation interest” and can be aggregated with other investment activities. When determining an exempt organization’s percentage ownership of stock in an S corporation, the exempt organization must apply the same rules for combining related interests that are used to determine whether a partnership interest is a QPI. An exempt organization may rely on the Schedule K–1 (Form 1120–S) that the exempt organization receives from the S corporation when determining its percentage ownership of the stock in such S corporation.

b. Employee Stock Ownership Plans

Section 512(e)(3) provides that section 512(e) does not apply to employer securities (within the meaning of section 409(l)) held by an employee stock ownership plan (ESOP) described in section 4975(e)(7). ESOPs holding S corporation stock (“S corporation ESOPs”) are subject to the limits imposed by section 409(p) on the concentration of S corporation ownership. Ownership includes shares allocated to the accounts of ESOP participants. Failing to meet the requirements of section 409(p) will result in the imposition of an excise tax on the S corporation and other adverse consequences to the ESOP and certain individuals. Although section 512(e) generally does not apply to S corporation ESOPs, the application of section 409(p) to an S corporation ESOP might give rise to UBTI. The primary means of avoiding a section 409(p) failure is for the S corporation ESOP to transfer some of its S corporation shares

to a non-ESOP portion of the plan or to another qualified retirement plan of the employer. See § 1.409(p)-1(b)(2)(v)(A)-(B). Such a transfer may result in a significant number of S corporation shares being held by the non-ESOP portion of an S corporation ESOP or by another section 401(a) plan (“transferee plan”). The transferred shares, no longer held in an ESOP, are not described in section 512(e)(3). Accordingly, the transferee plan treats the S corporation interest resulting from the transfer of the S corporation shares as an interest in an unrelated trade or business under the general rule of section 512(e)(1) and takes the amounts described in section 512(e)(1)(B) into account in computing UBTI. The Treasury Department and IRS anticipate that a transferee plan is not likely to have more than one S corporation interest. However, whether such S corporation interest may be aggregated with the investment activities of the transferee plan will depend on whether the S corporation interest is a qualifying S corporation interest. The Treasury Department and the IRS request comments on this issue.

5. Social Clubs, Voluntary Employees’ Beneficiary Associations, and Supplemental Unemployment Benefits Trusts

As noted in the Background section, section 512(a)(3) provides a special definition of UBTI for social clubs, VEBAs, and SUBs. Section 512(a)(3)(A) defines UBTI, in part, as “gross income (excluding exempt function income).” “Gross income” under section 61(a) includes “gains derived from dealings in property,” “interest,” “rents,” “royalties,” “dividends,” and “annuities.” See section 61(a)(3) through (8). Consistent with section 61(a), the gross income subject to the unrelated business income tax under section 512(a)(3) generally includes interest, annuities, dividends, royalties, rents, and capital gains because the modifications in section 512(b)(1), (2), (3), and (5) that exclude such amounts from UBTI for organizations subject to section 512(a)(1) are not available under section 512(a)(3). Accordingly, social clubs, VEBAs, and SUBs generally must include interest, dividends, royalties, rents, and capital gains in UBTI unless such amounts may be set aside for a purpose described in section 512(a)(3)(B)(i) or (ii) and therefore would be exempt function income excluded from UBTI under section 512(a)(3)(A).

Section 512(a)(3)(B) defines “exempt function income” as (1) “the gross income from dues, fees, charges, or similar amounts paid by members of the

organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization;” and (2) “all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to [section 512(a)(1)]) which is set aside” for one of the purposes described in section 512(a)(3)(B)(i) or (ii). Such amounts set aside include reasonable costs of administration directly connected with a purpose described in section 512(a)(3)(B)(i) or (ii).

Section 512(a)(3)(B)(i) includes in exempt function income amounts set aside for a purpose specified in section 170(c)(4), that is, exclusively for religious, charitable, scientific, literary, or educational purposes. In the case of a VEBA or SUB, section 512(a)(3)(B)(ii) includes in exempt function income amounts set aside to provide for the payment of life, sick, accident, or other benefits. Section 512(a)(3)(E) limits the amounts that may be set aside under section 512(a)(3)(B)(ii). In general, section 512(a)(3)(E)(i) provides that a set aside for any purpose described in section 512(a)(3)(B)(ii) may be taken into account as exempt function income only to the extent that such set aside does not result in an amount of assets set aside for such purpose in excess of the account limit determined under section 419A (without regard to section 419A(f)(6)) for the taxable year (not taking into account any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits).

In determining what income may be set aside under 512(a)(3)(B)(i) or (ii), the income available is “all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to [section 512(a)(1)].” This parenthetical language, by referencing “the gross income from any unrelated trade or business computed as if the organization was subject to [section 512(a)(1)],” pulls in the modifications of section 512(b) applicable to that computation. Accordingly, amounts excluded from UBTI under section 512(a) via the modifications in section 512(b) (such as interest, dividends, royalties, rents, and capital gains) are available to be set aside for the purposes of section 512(a)(3)(B)(i) and (ii) and may constitute exempt function income, subject to the other applicable limitations.

For example, if a social club has interest and dividends, and does not set aside any amount of such interest or dividends for a purpose specified in section 170(c)(4), then the full amount of the interest and dividends would constitute UBTI under section 512(a)(3). However, if the social club sets aside any amount of the interest or dividends for a purpose specified in section 170(c)(4), the amount of the interest and dividends set aside would be excluded from the calculation of UBTI under section 512(a)(3)(B)(i) as exempt function income (provided that such amount set aside actually is used for a purpose specified in section 170(c)(4)). Similarly, a VEBA with interest and dividends may set aside amounts to provide for the payment of life, sick, accident, or other benefits, subject to the limitations of section 512(a)(3)(E).⁴ Such amount set aside will be excluded from UBTI as exempt function income (provided that such amount actually is used to provide for the payment of benefits).

Notice 2018-67 anticipated that the rules issued regarding how an exempt organization identifies separate trades or businesses for purposes of section 512(a)(6)(A) generally would apply under both section 512(a)(1) and (3). Nonetheless, because social clubs, VEBAs, and SUBs are taxed differently than other exempt organizations under section 511, Notice 2018-67 requested comments regarding any additional considerations that should be given to how section 512(a)(6) applies within the context of section 512(a)(3), and, in particular, how the income from investment activities of these organizations should be treated for purposes of section 512(a)(6).

Commenters generally agreed that social clubs should be subject to the same rules as exempt organizations subject to section 512(a)(1) when determining whether the social club is subject to section 512(a)(6). A social club therefore would identify its unrelated trades or businesses using NAICS codes and treat the income derived from investment activities as a separate unrelated trade or business. Only one commenter addressed how section 512(a)(6) should apply to VEBAs. This commenter suggested that VEBAs would not be subject to section 512(a)(6) because the unrelated trade or business activities of the VEBA could be identified under one NAICS 6-digit code—the code for health and welfare funds (525120). However, as explained in section 1.a.i of this preamble, an exempt organization cannot use a

⁴ See Treas. Reg. § 1.512(a)-5(c).

NAICS 2-digit code describing the activities the conduct of which is substantially related to the exercise or performance by such exempt organization of the purpose or function constituting the basis for its exemption under section 501. No commenter addressed how section 512(a)(6) should apply to a SUB.

Consistent with the statement made in Notice 2018–67, the Treasury Department and the IRS have determined that a social club, VEBA, or SUB will determine whether it has more than one unrelated trade or business in the same manner as an exempt organization subject to section 512(a)(1) except as discussed in sections 5.a and b of this preamble.

a. Investment Activities

As discussed in section 2 of this preamble, the proposed regulations treat certain “investment activities” (that is, QPIs, qualifying S corporation interests, and debt-financed property or properties) as a separate unrelated trade or business for purposes of section 512(a)(6) and the proposed regulations. Thus, a social club, VEBA, or SUB generally will treat the investment activities specifically listed in the proposed regulations as a separate unrelated trade or business for purposes of section 512(a)(6). Nonetheless, because UBTI is defined differently for social clubs, VEBAs, and SUBs, the proposed regulations clarify that, in addition to other investment activities treated as a separate unrelated trade or business for purposes of section 512(a)(6), gross income from the investment activities of a social club, VEBA, or SUB also includes specific amounts discussed in sections 5.a.i. and ii of this preamble. The Treasury Department and the IRS request comments regarding any unintended consequences, in areas other than the unrelated business income tax, resulting from the treatment of investment activity as an unrelated trade or business for purposes of section 512(a)(6) for VEBAs and SUBs.

i. Amounts Described in Section 512(b)(1), (2), (3), and (5)

Because the modifications in section 512(b)(1), (2), (3), and (5) are not available under section 512(a)(3), social clubs, VEBAs, and SUBs generally must include interest, dividends, royalties, rents, and capital gains in UBTI under section 512(a)(3)(A) unless such amounts are set aside for a purpose described in section 512(a)(3)(B)(i) or

(ii).⁵ As stated in section 2.a of this preamble, interest, dividends, royalties, rents, and capital gains generally are considered income from investment activities. Accordingly, the proposed regulations provide that, for purposes of section 512(a)(6), UBTI from the investment activities of a social club, VEBA, or SUB includes any amount that would be excluded from the calculation of UBTI under section 512(b)(1), (2), (3), or (5) if the social club, VEBA, or SUB were subject to section 512(a)(1).

ii. Amounts Set Aside but Used for Another Purpose and Amounts in Excess of Account Limits

Section 512(a)(3)(B) provides that, if an amount which is attributable to income set aside for a purpose described in section 512(a)(3)(B)(i) or (ii) is used for a purpose other than one described therein, such amount shall be included in UBTI under section 512(a)(3)(A). Furthermore, with respect to a VEBA or SUB, the amount set aside may not be in excess of the set aside limit under section 512(a)(3)(E) and any amount in excess of this limit is nonexempt function income included in UBTI under section 512(a)(3)(A).

As discussed in section 5.a.i of this preamble, the amounts that may be set aside under section 512(a)(3)(B)(i) or (ii) are part of the social club, VEBA, or SUB’s investment activities. Therefore, the proposed regulations also provide that UBTI from the investment activities of a social club, VEBA, or SUB includes any amount that is attributable to income set aside (and not in excess of the set aside limit described in section 512(a)(3)(E)), but not used, for a purpose described in section 512(a)(3)(B)(i) or (ii) and any amount in excess of the set aside limit described in section 512(a)(3)(E).

b. Social Club Activities

i. Limitation on Investment Activities

Notice 2018–67 provided that the interim and transition rules for certain partnership interests did not apply to social clubs described in section 501(c)(7), pending receipt of comments and additional consideration of the issues specific to social clubs. Section 501(c)(7) requires that “substantially all of the activities” of an organization described therein be “for pleasure, recreation, and other nonprofitable purposes.” Accordingly, a social club has specific limits on the amount of

nonexempt function income that may be earned without endangering its tax-exempt status. While the Code does not provide more detail, intended limits are described in legislative history. *See* S. Rep. No. 94–1318 (1976), at 4–5. Additionally, Congress did not intend social clubs to receive, within these limits, non-traditional, unrelated business income. *Id.* Accordingly, consistent with Notice 2018–67, the proposed regulations provide that the QPI rule and the transition rule do not apply to social clubs because social clubs should not be invested in partnerships that would generally be conducting non-traditional, unrelated trades or businesses that generate more than a de minimis amount of UBTI. In this regard, a partnership interest meeting the requirements of the de minimis rule in these proposed regulations is not the same as a partnership interest generating only de minimis amounts of UBTI from non-traditional, unrelated trades or businesses. Thus, the Treasury Department and the IRS do not consider the administrative convenience rationale supporting the QPI rule as relevant for social clubs.

ii. Nonmember Activities

Two commenters requested that a social club be permitted to treat all nonmember activities as one unrelated trade or business for purposes of section 512(a)(6). One of these commenters argued that a social club could not easily separate its nonmember activities into separate unrelated trades or businesses because social clubs do not generally maintain separate books and records for the various locations in which sales to nonmembers may occur, such as in dining facilities or retail stores. The other commenter added that separating a social club’s nonmember activities into more than one unrelated trade or business would result in substantial administrative burden. The commenters describe the variety of activities in which social clubs engage, including food and beverage sales in club dining facilities and on club grounds (such as at pools or on golf courses and tennis courts); retail sales; greens fees; and space rental fees, whether or not they include substantial services.

As generally discussed in section 5 of this preamble, under the proposed regulations, a social club with nonmember income is subject to the same rules for identifying its unrelated trades or businesses as an organization subject to the rules of section 512(a)(1). Further, as discussed in section 1.a.i of this preamble, a social club cannot use

⁵ As explained in the introduction to section 5 of this preamble, treating the investment activities of a social club, VEBA, or SUB as an unrelated trade or business for purposes of section 512(a)(6) does not affect the amounts that may be set aside under section 512(a)(3)(B)(i) or (ii).

the NAICS 2-digit code generally describing social clubs (71) to describe all its non-member income because the NAICS code used must describe its separate unrelated trade or business and not the purpose for which it is exempt. While this code may describe some of a social club's non-member income, such as greens fees, other NAICS codes are more appropriate to describe other non-member income, such as merchandise sales (45) and food and beverage services (72). Accordingly, a social club must identify its separate unrelated trades or businesses in accordance with the rule described in section 1 of this preamble like an exempt organization subject to section 512(a)(1).

iii. Nonrecurring Events

The Treasury Department and the IRS recognize that UBTI within the meaning of section 512(a)(3) includes gross income without regard to a specific determination regarding the associated activities' qualification as an unrelated trade or business (within the meaning of section 513) because UBTI under section 512(a)(3) includes "all gross income (excluding exempt function income)." For example, one commenter requested guidance on how to treat income from social club events that are not anticipated to reoccur. The commenter provides as an example the hosting of a professional golf tournament when similar tournaments are not held in the same location on an annual basis. The commenter suggested that events such that occur once, or seldom, in the life of a social club, should be classified as a single trade or business under section 512(a)(6).

As explained in section 1.a of this preamble, these proposed regulations generally require an exempt organization to identify its separate unrelated trades or businesses using the NAICS 2-digit code that most accurately describes each trade or business. Whether an infrequent or possibly nonrecurring event constitutes a separate unrelated trade or business or whether such event is part of another trade or business (including, in some cases, part of the social club's investment activities) depends on the facts and circumstances of each social club and the event at issue, including the scope of activities as part of the event. While such determination is not necessary for including such income in UBTI under section 512(a)(3), identification of separate unrelated trades or businesses is necessary for applying section 512(a)(6). The Treasury Department and the IRS request comments regarding the particular facts

and circumstances that should be considered by a social club when determining whether a non-recurring event should be treated as a separate unrelated trade or business, part of a larger trade or business, or as part of a social club's investment activities for purposes of section 512(a)(6).

iv. Activities Without a Profit Motive

One commenter requested that the Treasury Department and the IRS clarify that nonmember activities conducted without intent to profit are not unrelated trades or businesses. The Treasury Department and the IRS do not address this comment in the proposed regulations because it is adequately addressed by existing precedent. *See, e.g., Portland Golf Club*, 497 U.S. at 164 (1990); Rev. Rul. 81-69, 1981-1 C.B. 351.

6. Total UBTI and the Charitable Contribution Deduction

Consistent with section 512(a)(6)(B), the proposed regulations provide that the total UBTI of an exempt organization with more than one unrelated trade or business is the sum of the UBTI computed with respect to each separate unrelated trade or business (as identified under the proposed regulations), less the specific deduction under section 512(b)(12). The proposed regulations also state that, for purposes of calculating an exempt organization's total UBTI, the UBTI with respect to any separate unrelated trade or business identified under the proposed regulations shall not be less than zero. *See* section 512(a)(6)(C).

Additionally, section 512(b)(10) and (11) permits exempt organizations to take the deduction under section 170 for charitable contributions whether or not the deduction is directly connected with the carrying on of an unrelated trade or business. The deduction is computed under section 170 except as otherwise provided in section 512(b)(10) and (11) and the Treasury regulations thereunder. For an exempt organization described in section 511(a), the deduction allowed by section 170 is limited to 10 percent of the exempt organization's UBTI computed without the benefit of section 512(b)(10). For a trust described in section 511(b), the deduction allowed by section 170 is limited as prescribed by section 170(b)(1)(A) and (B) determined with reference to UBTI computed without the benefit of section 512(b)(11).

At least one commenter recommended that the charitable contribution deductions permitted under section 512(b)(10) and (11) be taken against total UBTI calculated

under section 512(a)(6)(B) rather than being allocated among unrelated trades or businesses. Additionally, the JCT stated that "[i]t is not intended that an exempt organization that has more than one unrelated trade or business be required to allocate its deductible charitable contributions among its various unrelated trades or businesses." General Explanation, at 293 n.1377. The Treasury Department and the IRS agree. Thus, these proposed regulations clarify in new § 1.512(b)-1(g)(4) that the term "unrelated business taxable income" as used in section 512(b)(10) and (11) refers to UBTI after application of section 512(a)(6).

Under section 170(d)(1)(A), exempt organizations generally are permitted to carry over charitable contributions that exceed the organization's contribution base in a taxable year. Section 170(d)(1)(B) provides a special rule when an exempt organization has both NOL carryovers and excess contributions. In the case of an exempt organization with more than one unrelated trade or business, the function of this special rule is complicated by the requirement in section 512(a)(6)(A) to calculate NOLs separately with respect to each trade or business (see section 7 of this preamble). The Treasury Department and the IRS recognize that an ordering rule may be necessary to clarify how the special rule in section 170(d)(1)(B) operates when an exempt organization has NOL carry overs in more than one unrelated trade or business. Accordingly, the Treasury Department and the IRS request comments on this issue.

7. NOLs and UBTI

a. NOL Deduction Calculated Separately With Respect to Each Trade or Business

Section 512(b)(6), which was not changed by the TCJA, generally allows an exempt organization subject to the unrelated business income tax under section 511, including an exempt organization with more than one unrelated trade or business, to take the NOL deduction provided in section 172. Section 512(b)(6)(A) states that the NOL for any taxable year, the amount of the NOL carryback or carryover to any taxable year, and the NOL deduction for any taxable year shall be determined under section 172 without taking into account any amount of income or deduction that is excluded under section 512(b) in computing UBTI. For example, a loss attributable to an unrelated trade or business is not to be reduced by reason of the receipt of dividend income. *See* § 1.512(b)-1(e)(1). An NOL carryover is allowed only from

a taxable year for which the taxpayer is subject to the provisions of section 511, or a corresponding provision of prior law. See section 512(b)(6)(B); § 1.512(b)-1(e)(3).

Notice 2018-67 explained that section 512(a)(6) changes how an exempt organization with more than one unrelated trade or business calculates and takes NOLs into account with respect to a trade or business. Specifically, section 512(a)(6)(A) requires such an exempt organization to calculate UBTI, “including for purposes of determining any NOL deduction,” separately with respect to each trade or business for taxable years beginning after December 31, 2017. The legislative intent behind this change is to allow an NOL deduction “only with respect to a trade or business from which the loss arose.” H.R. Rep. No. 115-466, at 547. Accordingly, consistent with the language of section 512(a)(6)(A) and legislative intent, the proposed regulations provide that an exempt organization with more than one unrelated trade or business determines the NOL deduction allowed by sections 172(a) and 512(b)(6) separately with respect to each of its unrelated trades or businesses. The proposed regulations clarify that, if an exempt organization has more than one unrelated trade or business, § 1.512(b)-1(e), which explains the application of section 172 within the context of the unrelated business income tax, applies separately with respect to each such unrelated trade or business. Additionally, the proposed regulations add a new paragraph to § 1.512(b)-1(e) that refers an exempt organization with more than one unrelated trade or business to new proposed § 1.512(a)-6(h) regarding the computation of the NOL deduction.

b. Coordination of NOLs

To preserve NOLs from tax years prior to the effective date of the TCJA, Congress created a special transition rule for NOLs arising in a taxable year beginning before January 1, 2018 (“pre-2018 NOLs”). Section 13702(b)(2) of the TCJA provides that section 512(a)(6)(A) does not apply to pre-2018 NOLs; rather, pre-2018 NOLs are taken against the total UBTI calculated under section 512(a)(6)(B). However, when an exempt organization has pre-2018 NOLs, which are subject to a carry-forward limitation, and NOLs arising in a taxable year beginning after December 31, 2017 (“post-2017 NOLs”), which are not, a question arises regarding the order in which such losses should be taken.

In Notice 2018-67, the Treasury Department and the IRS noted that section 512(a)(6) may have changed the

order in which an organization would ordinarily take losses. For example, if section 512(a)(6) is read as a more specific ordering rule for purposes of calculating and taking the NOL deduction than the one found in section 172, post-2017 NOLs would be calculated and taken before pre-2018 NOLs because the UBTI with respect to each separate unrelated trade or business is calculated under section 512(a)(6)(A) before calculating total UBTI under section 512(a)(6)(B). Accordingly, Notice 2018-67 requested comments regarding how the NOL deduction should be taken under section 512(a)(6) by exempt organizations with more than one unrelated trade or business and, in particular, by such organizations with both pre-2018 and post-2017 NOLs. Notice 2018-67 also requested comments on the ordering of pre-2018 and post-2017 NOLs and the potential treatment of pre-2018 NOLs that may expire in a given tax year if not taken before post-2017 NOLs.

In response to Notice 2018-67, several commenters addressed possible ordering rules for organizations subject to section 512(a)(6). These commenters noted that the language should not alter the ordering rules under section 172 such that pre-2018 NOLs should be allowed prior to post-2017 NOLs, especially because pre-2018 NOLs remain subject to a carry-forward limitation.

The language of section 512(a)(6) and section 13702(b) of the TCJA do not alter the ordering rules under section 172. Accordingly, the proposed regulations provide that an exempt organization with both pre-2018 and post-2017 NOLs will deduct its pre-2018 NOLs from its total UBTI under section 512(a)(6)(B) before deducting any post-2017 NOLs with regard to a separate unrelated trade or business from the UBTI from such unrelated trade or business. 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.

c. Legislative Changes to Section 172

At the same time Congress added section 512(a)(6), it also made extensive changes to section 172. These changes included limiting the NOL deduction to 80 percent of taxable income, prohibiting the carryback of NOLs (except for certain farming losses and in the case of certain insurance companies), and allowing the indefinite carryover of NOLs. *Id.* However, shortly before publication of these proposed regulations, Congress enacted the

Coronavirus Aid, Relief, and Economic Security Act, Public Law 116-136, 134 Stat. 281 (2020) (CARES Act). Section 2303 of the CARES Act temporarily repeals the 80 percent income limitation and permits the carryback of NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the taxable year of such loss. The Treasury Department and the IRS will further consider how the changes to section 172 made by the CARES Act affect the calculation of UBTI under section 512(a)(6) and may issue additional guidance on the issue.

8. Form 990-T

One commenter suggested updating the Form 990-T to provide space for an exempt organization to disclose and describe the method chosen for identifying the separate unrelated trades or businesses being reported on Form 990-T. This commenter recommended either the addition of a “miscellaneous schedule” similar to Schedule O, “Supplemental Information to Form 990 or 990-EZ,” of the Form 990, “Return of Organization Exempt from Income Tax,” or the inclusion of space on the schedules to the Form 990-T to make such disclosure. This commenter also recommended that the IRS update the instructions to the Form 990-T either to include a more complete list of applicable NAICS codes or to state clearly where additional codes may be found. The Treasury Department and the IRS recognize that changes to the Form 990-T and related schedules may be necessary. In particular, the Treasury Department and the IRS recognize that additional instructions are required regarding how separate unrelated trades or businesses identified under the special rules (rather than NAICS)—such as for investment activities (see section 2 of this preamble), inclusions of income derived from certain controlled entities (see section 3 of this preamble), and non-qualifying S corporation interests (see section 4 of this preamble)—are identified on Form 990-T and related schedules. Accordingly, the IRS intends to update the Form 990-T and related schedules, and the instructions thereto, as appropriate.

9. Individual Retirement Accounts

As previously discussed in the Background section of this preamble, section 513(b) provides a special definition of “unrelated trade or business” for a qualified retirement plan or for a trust that is exempt from tax under section 501(c)(17) (SUB). Section 513(b) defines “unrelated trade or business,” as any trade or business

regularly carried on by such trust or by a partnership of which it is a member.

Notice 2018–67 stated in a footnote that, because IRAs described in section 408 are, under section 408(e), subject to the tax imposed by section 511, and IRAs are most similar to qualified retirement plans, it is reasonable to apply the definition of “unrelated trade or business” described in section 513(b) to IRAs. The footnote stated that the Treasury Department and the IRS intended to provide that the section 513(b) definition of unrelated trade or business should be used for IRAs subject to the unrelated business income tax in section 511 pursuant to section 408(e). Consistent with this statement, the proposed regulations add a new paragraph to § 1.513–1 clarifying that the section 513(b) definition of “unrelated trade or business” applies to IRAs. Accordingly, § 1.513–1(f) provides that an IRA will apply the definition of “unrelated trade or business” in section 513(b) when determining whether it has more than one unrelated trade or business within the meaning of section 512(a)(6). The proposed regulations make corresponding changes to § 1.513(b)–1(a) to account for the new paragraph added at § 1.513(b)–1(f).

10. Inclusions of Subpart F Income and Global Intangible Low-Taxed Income

An inclusion of subpart F income under section 951(a)(1)(A) is treated in the same manner as a dividend for purposes of section 512(b)(1). Accordingly, an inclusion of subpart F income generally is excluded from the calculation of UBTI under section 512(b)(1). Notice 2018–67 explained that Congress approved the IRS’s long-standing position when Congress enacted section 512(b)(17). Furthermore, Notice 2018–67 provided that an inclusion of GILTI under section 951A(a) should be treated in the same manner as an inclusion of subpart F income under section 951(a)(1)(A) for purposes of section 512(b)(1) and therefore would be treated as a dividend that generally is excluded from UBTI. Two commenters explicitly agreed with these conclusions and one commenter requested that the Treasury Department and the IRS revise the Treasury Regulations consistent with these conclusions. Accordingly, the proposed regulations revise § 1.512(b)–1(a) to clarify that an inclusion of subpart F income under section 951(a)(1)(A) is treated in the same manner as a dividend for purposes of section 512(b)(1) and that an inclusion of GILTI under section 951A(a) is treated in the same manner as an inclusion of subpart

F income under section 951(a)(1)(A) for purposes of section 512(b)(1).

11. Public Support

A question has arisen regarding whether the enactment of section 512(a)(6) impacts the calculation of public support under sections 509(a)(1) and 170(b)(1)(A)(vi) and under section 509(a)(2). Exempt organizations described in section 501(c)(3) that are classified as publicly supported charities under these sections must calculate public support annually on Form 990, Schedule A, “Public Charity Status and Public Support.” In general, public support is expressed as a percentage of support from certain public sources over total support. See § 1.170A–9(f) (definition of section 170(b)(1)(A)(vi) organization); § 1.509(a)–3 (publicly supported organizations).

Section 512(a)(6) potentially impacts two aspects of the public support test. First, section 512(a)(6) potentially impacts the calculation of total support under section 509(d), a number which is used for purposes of both section 509(a)(1) and (2). Specifically, section 509(d)(3) includes, in the calculation of total support, the organization’s net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business. Although section 509(d)(3) does not specifically cross-reference section 512, the term “unrelated business activities” can be read broadly to include, but not be limited to, UBTI within the meaning of section 512. If this is the case, then an organization with more than one unrelated trade or business could be required to apply section 512(a)(6) in determining its total support, which may increase its amount of total support because the losses from one unrelated trade or business cannot offset the gains from another unrelated trade or business.

Second, section 512(a)(6) potentially impacts the not-more-than-one-third support test under section 509(a)(2)(B), which requires calculation of the excess (if any) of the amount of UBTI (as defined in section 512) over the amount of the tax imposed by section 511. Unlike section 509(d)(3), which does not cross-reference section 512, the not-more-than-one-third support test specifically cross-references section 512. Accordingly, an organization with more than one unrelated trade or business could be required to apply section 512(a)(6) when determining whether it receives more than one-third of its support from non-public sources. If this is the case, application of section 512(a)(6) in this context may result in an

increase in support received from non-public sources, again, because of the inability to use losses from one unrelated trade or business to offset income from another unrelated trade or business.

If section 512(a)(6) applies in either context, organizations with more than one unrelated trade or business may have difficulty qualifying as publicly supported because of the potential increase in the calculated support from non-public sources as well as the potential increase in the calculated amount of total support. The Treasury Department and the IRS are not aware of any intent of Congress to change the public support test when enacting section 512(a)(6). Accordingly, the proposed regulations include revisions to §§ 1.170A–9(f) and 1.509(a)–3 to permit an organization with more than one unrelated trade or business to aggregate its net income and net losses from all of its unrelated business activities, including its unrelated trades or businesses within the meaning of section 512, for purposes of determining whether the organization is publicly supported. The Treasury Department and the IRS recognize that requiring different calculations for purposes of calculating public support and UBTI may impose a significant administrative burden on organizations with more than one unrelated trade or business. Accordingly, the Treasury Department and the IRS request comments regarding the application of section 512(a)(6) to the public support test.

12. Technical Correction of Inadvertently Omitted Regulatory Language

These proposed regulations make a technical correction to § 1.512(a)–1(b). In 1967, the Treasury Department and the IRS published § 1.512(a)–1 in the **Federal Register** (TD 6939, 32 FR 17660). Section 1.512(a)–1(b) explained that “[e]xpenses, depreciation and similar items attributable solely to the conduct of an unrelated business are proximately and primarily related to that business and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Internal Revenue Code.” An example followed this statement providing that, “[t]hus, for example, salaries of personnel employed full-time in carrying on an unrelated business are directly connected with the conduct of the unrelated business and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162.”

In 1975, the Treasury Department and the IRS revised § 1.512(a)–1(b) in regulations published in the **Federal Register** (TD 7392, 40 FR 58639). The final regulations omitted from the example the following language: “[t]hus, for example, salaries of personnel employed full-time in carrying on an unrelated business are directly.” However, the final regulations as published in the Cumulative Bulletin (1976–1 CB 162) contained this language. Accordingly, the Treasury Department and the IRS have concluded that this language was inadvertently omitted from the final regulations in 1975 and are making a technical correction to the regulations. Therefore, the proposed regulations include the omitted language in § 1.512(a)–1(b).

Proposed Applicability Dates

These regulations are proposed to apply to taxable years beginning on or after the date these regulations are published in the **Federal Register** as final regulations. For taxable years beginning before the date these regulations are published in the **Federal Register** as final regulations, an exempt organization may rely on a reasonable, good-faith interpretation of sections 511 through 514, considering all the facts and circumstances, when identifying separate unrelated trades or businesses for purposes of section 512(a)(6)(A). In addition, for these same taxable years, an exempt organization may rely on these proposed regulations in their entirety. Alternatively, for these same taxable years, an exempt organization may rely on the methods of aggregating or identifying separate trades or businesses provided in the Notice 2018–67.

Statement of Availability of IRS Documents

For copies of recently issued Revenue Procedures, Revenue Rulings, Notices, and other guidance published in the Internal Revenue Bulletin, please visit the IRS website at <http://www.irs.gov> or the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Special Analyses

I. Regulatory Planning and Review—Economic Analysis

Executive Orders 12866, 13563, and 13771 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health, and safety

effects; distributive impacts; and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

The proposed regulations have been designated as significant under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs (OIRA) has designated the proposed rulemaking as significant under section 1(b) of the Memorandum of Agreement. Accordingly, the proposed regulations have been reviewed by OMB. For purposes of Executive Order 13771, the proposed regulations are regulatory.

A. Background

Certain corporations, trusts, and other entities are exempt from Federal income taxation because of the specific functions they perform (“exempt organizations”). Examples include religious and charitable organizations. However, exempt organizations that engage in business activities that are not substantially related to their exempt purposes may have taxable income under section 511(a)(1) of the Internal Revenue Code (Code). For example, the income that a tax-exempt organization generates from the sale of advertising in its quarterly magazine is unrelated business taxable income (UBTI).

Prior to the Tax Cuts and Jobs Act (TCJA), UBTI was calculated by aggregating the net incomes from all the unrelated business activities conducted by an exempt organization. As a result, losses from one activity could be used to offset profits from another activity. New section 512(a)(6), enacted in the TCJA, provides that organizations with more than one unrelated trade or business calculate the taxable amounts separately for each trade or business so that losses only offset income from the same unrelated trade or business. The statutory language, however, does not specify standards for determining what activities would be considered the same or a different trade or business.

Previously, on September 4, 2018, the Treasury Department and the IRS published Notice 2018–67, 2018–36 I.R.B. 409 (the Notice), which discussed and solicited comments regarding various issues arising under section 512(a)(6) and set forth interim guidance and transition rules relating to that section. The Treasury Department and the IRS received 24 comments in response to the Notice. The proposed

regulations consider and respond to these comments.

The proposed regulations address the need for guidance by providing rules for determining when an exempt organization has more than one unrelated trade or business and how such an exempt organization computes UBTI under new section 512(a)(6). Specifically discussed below, the proposed regulations establish guidelines for (1) identifying separate unrelated trades or businesses; and (2) in certain cases, permitting an exempt organization to treat investment activities as one unrelated trade or business for purposes of computing UBTI.

B. Baseline

The Treasury Department has assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

C. Affected Entities

Prior tax law did not require reporting unrelated business income by separate activity so taxpayer counts are not available. However, the IRS estimates that less than 2 percent of exempt organizations would be affected. Potentially affected organizations are only those with more than one unrelated trade or business, a group likely to include colleges and universities, certain cultural organizations such as museums, and some tax-exempt hospitals.

Presently it is not possible to obtain accurate counts of the number of exempt organizations potentially affected by the proposed regulations, because prior law did not require disaggregation of the separate sources of UBTI and therefore the IRS does not have access to this level of detail on UBTI. Approximately 1.4 million exempt organizations filed some type of information or tax return with the IRS for fiscal year 2018.⁶ Only 188,000 exempt organizations filed Form 990–T, which is used to report UBTI. While not all Form 990–T filers also file an information return with the IRS, as an

⁶ See Internal Revenue Service Research, Applied Analytics, and Statistics, Statistics of Income Division Fiscal Year Return Projections for the United States Publication 6292 (Rev. 9–2019), Projected Returns 2019–2026. Exempt organizations generally must file an annual information return with IRS. See generally section 6033. However, churches and small organizations are exempt from this filing requirement. See section 6033(a)(3). Organizations that have more than \$1,000 in gross UBTI must also file Form 990–T to calculate their UBTI and tax. See section 512(b)(12) (providing a \$1,000 specific deduction).

upper bound estimate 14 percent of exempt organizations could be affected by the regulations. Within Form 990-T filers, only a smaller subset, primarily the largest organizations in certain categories, are expected to have more than one unrelated trade or business. Among the types of organizations expected to have more than one unrelated trade or business are colleges and universities, certain cultural organizations such as museums, and some tax-exempt hospitals.

Additional information on organizations that may be affected is provided by a 2018 Center on Nonprofits and Philanthropy (CNP) survey of 723 primarily large exempt organizations.⁷ Three-hundred and thirty of these organizations reported that they had filed a Form 990-T. Of these, 70 percent had revenues over \$10 million and most were educational or arts and cultural organizations. Only 46 organizations (14 percent of the surveyed organizations filing Form 990-T) reported having more than one source of UBTI and almost half of these had only two sources. Thus, the Treasury Department and the IRS project that if the CNP survey results applied to the population of Form 990-T filers, then less than 2 percent of exempt organizations would be affected by the proposed regulations and that these would tend to be large educational or arts and cultural organizations.

D. Economic Analysis of NPRM

The proposed regulations provide greater certainty to exempt organizations regarding how to compute UBTI and tax in response to the changes made by TCJA and adopt standards that balance the statutory intent of those changes and excessive burden that might result from some interpretations of such standards. They also improve economic efficiency by helping to ensure that similar exempt organizations are taxed similarly. In the absence of this guidance taxpayers might make different assumptions regarding how to calculate UBTI and tax.

This section describes the two provisions of the NPRM for which economic analysis is helpful and provides a qualitative economic analysis of each one.

i. Identifying Separate Trades or Businesses

As discussed above, section 512(a)(6) requires exempt organizations with

more than one unrelated trade or business to calculate UBTI separately for each trade or business so that losses are only used to offset income from the same unrelated trade or business. The Notice stated that the Treasury Department and the IRS were considering the use of NAICS codes to identify separate unrelated trades or businesses and, in the meantime, would consider the use of NAICS 6-digit codes to be reasonable for identifying separate unrelated trades or businesses. NAICS is an industry classification system for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. Each digit of the NAICS 6-digit codes describes an industry with increasing specificity.

In the Notice, the Treasury Department and the IRS requested comments regarding methods to identify separate unrelated trades or businesses in general and the use of NAICS codes in particular. As discussed further below, several commenters pointed out potential difficulties in using NAICS 6-digit codes and suggested using NAICS 2- or 3-digit codes; that is, a higher level of aggregation of business activity. The proposed regulations allow the use of NAICS 2-digit codes, thereby addressing the concerns raised in comments received and reducing compliance burdens for exempt organizations with multiple similar types of business activity.

Several commenters stated that the NAICS codes represented a workable system for identifying a separate unrelated trade or business. Not all commenters agreed as to what level of these codes should be used to group the various activities. Most of the commenters making recommendations on the NAICS codes rejected the use of NAICS 6-digit codes. These commenters noted that using NAICS 6-digit codes would result in significant compliance burden because an exempt organization would have to determine which of over 1,000 NAICS 6-digit codes most accurately describes its trades or businesses. Commenters noted that many NAICS 6-digit codes may apply to more than one trade or business activity or that no NAICS 6-digit code may exist to accurately describe a trade or business activity. Additionally, these commenters argued that the use of NAICS 6-digit codes could potentially require an exempt organization to split what has traditionally been considered one unrelated trade or business into multiple unrelated trades or businesses. Some commenters noted they would have to incur the costs of changing their accounting systems so as to collect the

information needed for separate NAICS 6-digit codes. These commenters suggested a range of code levels representing various levels of specificity from 2-digits up to 4-digits.

Reflecting comments on the Notice from potentially affected organizations, the Treasury Department and the IRS chose NAICS 2-digit codes for identifying unrelated trades or businesses. Allowing the use of NAICS 2-digit codes to identify separate unrelated trades or businesses reduces the compliance costs of affected organizations relative to the use of NAICS 6-digit codes. For example, different types of food services would be in the same NAICS 2-digit code as opposed to separate NAICS 6-digit codes. Similarly, different types of recreational activities, such as fitness centers and golf courses, would be in the same NAICS 2-digit code as opposed to separate NAICS 6-digit codes. A single facility might have elements fitting several of these categories, which could change over time when NAICS codes are revised.

The guidance provided in the proposed regulations also ensures that the tax liability is calculated similarly across taxpayers, avoiding situations where one taxpayer receives differential treatment compared to another taxpayer for fundamentally similar economic activity based on their differing reasonable, good-faith interpretation of the statute. In the absence of these proposed regulations, an exempt organization might be uncertain about whether an activity is one or more than one business activity. As a result, in the absence of the proposed regulations, similar institutions might take different positions and pay different amounts of tax, introducing economic inefficiency and inequity.

Since exempt organizations could use a reasonable and good-faith effort to interpret whether some trade and business activities would have to be reported separately, behavioral responses were likely muted. These regulations do provide greater certainty and flexibility such that compliance costs may be slightly lower for affected organizations.

The Treasury Department and the IRS solicit comments on the use of the NAICS 2-digit codes and comments that provide data, other evidence, or models that would enhance the rigor by which the final regulations might be developed.

ii. Aggregation of Investment Activities

The proposed regulation's treatment of investment activities will also provide clarity and reduce burdens for

⁷ See Elizabeth Boris and Joseph Cordes, "How the TCJA's New UBIT Provisions Will Affect Nonprofits," Urban Institute Research Report, January 2019.

exempt organizations. By providing more explicit rules for the treatment of investment activities, the proposed regulations reduce the uncertainty about what would be acceptable under the “reasonable, good-faith interpretation” provided in the Notice. Although investment income, such as interest and dividend income, is not generally taxed as UBTI, exempt organizations may engage in certain activities that the organization considers “investments” but that generate UBTI, such as debt-financed investments or investments through partnerships. Consistent with the guidance included in the Notice, the proposed regulations allow certain of this “investment” income to be aggregated and treated as a single trade or business. The proposed regulations further expand on the notice by providing a more developed rule for partnership income and explicitly list the other types of UBTI that can be aggregated as “investment” income in response to comments requesting additional clarification. As a result, the proposed regulations reduce the compliance burdens of exempt organizations of obtaining information from partnerships and simplify the calculation of UBTI when the income is generated from “investment” activities relative to the no-action baseline.

Given these proposed regulations follow and slightly expand the guidance in the Notice, investment responses are likely to be minimal. While some exempt organizations may have perceived a need to reorganize certain investments, such as in partnerships that qualify for aggregate treatment and thereby seek offset any losses, few would have been expected to do this reorganization prior to regulations being published.

iii. Summary

The proposed regulations provide rules for determining when an exempt organization has more than one unrelated trade or business and how such an exempt organization computes UBTI. In addition, the proposed regulations provide guidelines for when an exempt organization treats its investment activities as one unrelated trade or business for purposes of computing UBTI. In the absence of guidance, affected taxpayers may face more uncertainty when calculating their tax liability, a situation generally that could lead to greater conflicts with tax administrators. The Treasury Department and the IRS project that the proposed regulations will reduce taxpayer compliance burden relative to the no-action baseline. In addition, the Treasury Department and the IRS project that these regulations will affect a small number of exempt organizations. Based on this analysis, the Treasury Department and the IRS anticipate any economic effects of the proposed regulations will be modest.

II. Paperwork Reduction Act

The collection of information in these proposed regulations is in § 1.512(b)-6(a). This information is required to determine whether an exempt organization has more than one unrelated trade or business and therefore must report those unrelated trades or businesses on Form 990-T and related schedules. In 2018, the IRS released and invited comments on drafts of an earlier version of the Form 990-T and related schedules to give members of the public opportunity to comment on changes made to the Form 990-T, and the addition of a new schedule to report additional unrelated trades or businesses, as required by the enactment of section 512(a)(6). The IRS received no comments on the Form

990-T and related schedules during that comment period. Consequently, the IRS made Form 990-T available on January 8, 2019, and the new schedule for reporting additional unrelated trades or businesses available on January 25, 2019, for use by the public. The IRS intends that the burden of collections of information will be reflected in the burden associated with the Form 990 series under OMB approval number 1545-0047.

The paperwork burden estimate for tax-exempt organizations is reported under OMB control number 1545-0047, which represents a total estimated burden time, including all other related forms and schedules for corporations, of 52 billion hours and total estimated monetized costs of \$4.17 billion (\$2017). The burden estimates provided in the OMB control number are aggregate amounts that relate to the entire package of forms associated with the OMB control number and will in the future include, but not isolate, the estimated burden of these proposed regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by adoption of these proposed regulations. The Treasury Department and IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burden. No burden estimates specific to the proposed regulations are currently available. The Treasury Department has not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. Those estimates would capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations. The current status of the Paperwork Reduction Act submissions related to these proposed regulations is provided in the following table.

| Form | OMB control No. | Status |
|---|-----------------|--|
| 990 and related forms | 1545-0047 | Sixty-day notice published on 9/24/2019. Thirty-day notice published on 12/31/2019. Approved by OIRA on 2/12/2020. |
| Link: https://www.irs.gov/forms-pubs/about-form-990 . | | |

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to the Form 990-T and related schedules that reflect

the information collections contained in these proposed regulations will be made available for public comment at <http://apps.irs.gov/app/picklist/list/draftTaxForms.html>. The revised Form 990-T and related schedules will not be finalized until after these forms have been approved by OMB under the PRA. Comments on these forms can be submitted at [https://www.irs.gov/forms-](https://www.irs.gov/forms-pubs/comment-on-tax-forms-and-publications)

[pubs/comment-on-tax-forms-and-publications](https://www.irs.gov/forms-pubs/comment-on-tax-forms-and-publications).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may

become material in the administration of any internal revenue laws. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6) (RFA), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities. As discussed elsewhere in this preamble, these proposed regulations apply to all exempt organizations with UBTI, but only to the extent required to determine if an exempt organization has more than one unrelated trade or business. If an exempt organization only has one unrelated trade or business, these regulations do not apply and the exempt organization determines UBTI under section 512(a)(1) or section 512(a)(3), as appropriate. If an exempt organization has more than one unrelated trade or business, these proposed regulations provide instructions for computing UBTI separately with respect to each such unrelated trade or business.

These proposed regulations are not likely to affect a substantial number of small entities. According to the IRS Data Book, 1,835,534 exempt organizations existed in 2018. Internal Revenue Service, Publication 55B, Internal Revenue Service Data Book 2018, 57 (May 2019). However, only 188,334 Form 990-Ts were filed in 2018. Internal Revenue Service, Publication 6292, Fiscal Year Return Projects for the United States: 2019–2026, Fall 2019 4 (September 2019). The IRS expects that less than 10 percent of the exempt organizations population will be affected by these proposed regulations because the exempt organizations filing Form 990-T include entities not included in the definition of “small entities,” such as large hospital systems and universities. Therefore, this proposed regulation is not likely to affect a substantial number of small entities.

Even if the regulations affected a substantial number of small entities, the economic impact of this proposed rule is not likely to be significant. An organization affected by this rule, with more than one unrelated trade or business, completes Part I and Part II on page 1 of Form 990-T and completes and attaches a separate schedule for each additional unrelated trade or business. Affected taxpayers have been reporting UBTI on form 990-T for the previous two tax years. As discussed elsewhere in this preamble, these regulations would provide certainty and

guidance for these organizations. In the absence of this guidance, affected taxpayers may face more uncertainty when calculating their tax liability, a situation generally that could lead to greater conflicts with tax administrators. Although affected taxpayers will have to spend time reading and understanding these regulations, the Treasury Department and the IRS project that the proposed regulations provide certainty and guidance that will reduce taxpayer compliance burden for large and small entity taxpayers.

Notwithstanding this certification, the Treasury Department and the IRS invite comments on the impact this rule may have on small entities.

Pursuant to section 7805(f), this proposed rule has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are timely submitted to the IRS as prescribed in the preamble under the **ADDRESSES** section. All comments submitted will be made available at <https://www.regulations.gov> or upon request.

A public hearing on these proposed regulations will be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of this notice of proposed rulemaking is Stephanie N. Robbins, Office of the Chief Counsel (Employee Benefits, Exempt Organizations and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.170A–9 is proposed to be amended by:

- 1. Adding new paragraph (f)(7)(v).
- 2. Adding new paragraph (k)(3).

The additions read as follows:

§ 1.170A–9 Definition of section 170(b)(1)(A) organization.

* * * * *

(f) * * *

(7) * * *

(v) *Unrelated business activities.* The term *net income from unrelated business activities* in section 509(d)(3) includes (but is not limited to) an organization’s unrelated business taxable income (UBTI) within the meaning of section 512. However, when calculating UBTI for purposes of determining support (within the meaning of paragraph (f)(7)(i) of this section), section 512(a)(6) does not apply. Accordingly, in the case of an organization that derives gross income from the regular conduct of two or more unrelated business activities, support includes the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities.

* * * * *

(k) * * *

(3) *Applicability date.* Paragraph (f)(7)(v) of this section applies to taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**].

■ **Par. 3.** Section 1.509(a)–3 is proposed to be amended by:

- 1. Revising the first sentence of paragraph (a)(3)(i).
- 2. Redesignating paragraph (a)(4) as paragraph (a)(5).
- 3. Adding new paragraph (a)(4).
- 4. Revising paragraph (o).

The revisions and additions read as follows:

§ 1.509(a)–3 Broadly, publicly supported organizations.

(a) * * *

(3) * * *

(i) * * *

An organization will meet the not-more-than-one-third support test under section 509(a)(2)(B) if it normally (within the meaning of paragraph (c) or (d) of this section) receives not more than one-third of its support in each taxable year from the sum of its gross investment income (as defined in section 509(e)) and the excess (if any) of the amount of its unrelated business taxable income (as defined in section 512, without regard to section 512(a)(6)) derived from trades or businesses that were acquired by the organization after June 30, 1975, over the amount of tax imposed on such income by section 511.

* * * * *

(4) *Unrelated business activities.* The denominator of the one-third support fraction and the denominator of the not-more-than-one-third support fraction both include net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business. The term *net income from unrelated business activities* includes (but is not limited to) an organization's unrelated business taxable income (UBTI) within the meaning of section 512. However, when calculating UBTI for purposes of determining the denominator of both support fractions, section 512(a)(6) does not apply. Accordingly, in the case of an organization that derives gross income from the regular conduct of two or more unrelated business activities, support includes the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities.

* * * * *

(o) *Applicability date.* This section generally applies to taxable years beginning after December 31, 1969, except paragraphs (a)(3)(i) and (a)(4) of this section apply to taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER]. For taxable years beginning before [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER], see these paragraphs as in effect and contained in 26 CFR part 1 revised as of April 1, 2019.

■ **Par. 4.** Section 1.512(a)-1 is proposed to be amended by:

- 1. Revising the first and fourth sentence of paragraph (a).
- 2. Revising the first and second sentence of paragraph (b).
- 3. Adding two sentences to the end of paragraph (c).
- 4. Revising paragraph (h).

The revisions and additions read as follows:

§ 1.512(a)-1 Definition.

(a) * * * Except as otherwise provided in § 1.512(a)-3, § 1.512(a)-4, or paragraph (f) of this section, section 512(a)(1) defines *unrelated business taxable income* as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Internal Revenue Code (Code) which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in § 1.512(b)-1. * * * In the case of an organization with more than one unrelated trade or business, unrelated business taxable income is calculated

separately with respect to each such trade or business. See § 1.512(a)-6.

* * *

(b) * * * Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Code. Thus, for example, salaries of personnel employed full-time in carrying on unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162.

(c) * * * However, allocation of expenses, depreciation, and similar items using an unadjusted gross-to-gross method is not reasonable. For example, if a social club charges nonmembers a higher price than it charges members for the same good or service, it must adjust the price of the good or service provided to members for purposes of determining the allocation of indirect expenses to avoid overstating the deductions allocable to the unrelated business activity of providing goods and services to nonmembers.

* * * * *

(h) *Applicability date.* This section generally applies to taxable years beginning after December 12, 1967, except as provided in paragraph (g)(2) of this section, and except that paragraphs (a) through (c) of this section apply to taxable years beginning on or [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER]. For taxable years beginning before [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER], see these paragraphs as in effect and contained in 26 CFR part 1 revised as of April 1, 2019.

■ **Par. 5.** Section 1.512(a)-6 is proposed to be added to read as follows:

§ 1.512 (a)-6 Special rule for organizations with more than one unrelated trade or business.

(a) *More than one unrelated trade or business—(1) In general.* An organization with more than one unrelated trade or business must compute unrelated business taxable income (UBTI), including for purposes of determining any net operating loss (NOL) deduction, separately with respect to each such trade or business, without regard to the specific deduction in section 512(b)(12). An organization with more than one unrelated trade or

business computes its total UBTI under paragraph (g) of this section.

(2) *Separate trades or businesses.* For purposes of section 512(a)(6)(A) and paragraph (a)(1) of this section, an organization identifies its separate unrelated trades or businesses using the methods described in paragraphs (b) through (e) of this section.

(b) *North American Industry Classification System—(1) In general.* Except as provided in paragraphs (c) through (e) of this section, an organization will 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) that most accurately describes the trade or business. The NAICS 2-digit code chosen must identify the unrelated trade or business in which the organization engages (directly or indirectly) and not the activities the conduct of which are substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). For example, a college or university described in section 501(c)(3) cannot use the NAICS 2-digit code for educational services to identify all its separate unrelated trades or businesses, and a qualified retirement plan described in section 401(a) cannot use the NAICS 2-digit code for finance and insurance to identify all of its unrelated trades or businesses.

(2) *Codes only reported once.* An organization will report each NAICS 2-digit code only once. For example, a hospital organization that operates several hospital facilities in a geographic area (or multiple geographic areas), all of which include pharmacies that sell goods to the general public, would include all the pharmacies under the NAICS 2-digit code for retail trade, regardless of whether the hospital organization keeps separate books and records for each pharmacy.

(3) *Erroneous codes.* Once an organization has identified a separate unrelated trade or business using a particular NAICS 2-digit code, the organization may not change the NAICS 2-digit code describing that unrelated trade or business unless the organization can show that the NAICS 2-digit code chosen was due to an unintentional error and that another NAICS 2-digit code more accurately describes the trade or business.

(c) *Activities in the nature of investments*—(1) *In general.* An organization's activities in the nature of investments (investment activities) are treated collectively as a separate unrelated trade or business for purposes of section 512(a)(6)(A) and paragraph (a) of this section. Except as provided in paragraphs (c)(6) and (c)(8) of this section, an organization's investment activities are limited to its—

(i) Qualifying partnership interests (described in paragraph (c)(2) of this section);

(ii) Qualifying S corporation interests (described in paragraph (e)(2)(i) of this section); and

(iii) Debt-financed property or properties (within the meaning of section 514).

(2) *Qualifying partnership interests*—

(i) *Directly-held partnership interests.* An interest in a partnership is a qualifying partnership interest (QPI) if the exempt organization holds a direct interest in a partnership (directly-held partnership interest) that meets the requirements of either the de minimis test (described in paragraph (c)(3) of this section) or the control test (described in paragraph (c)(4) of this section).

(ii) *Indirectly-held partnership interests.* If an organization does not control (within the meaning of paragraph (c)(4)(iii) of this section) a partnership in which the organization holds a direct interest but that directly-held partnership interest is not a QPI because the organization holds more than 20 percent of the capital interest, any partnership in which the organization holds an indirect interest through the directly-held partnership interest (indirectly-held partnership interest) may be a QPI if the indirectly-held partnership interest meets the requirements of the de minimis test (described in paragraph (c)(3) of this section) (look-through rule). For example, if an organization directly holds 50 percent of the capital interests of a partnership that it does not control and the directly-held partnership holds 4 percent of the capital and profits interests of lower-tier partnership A, and 10 percent of the capital and profits interests of lower-tier partnership B, the organization may aggregate its interest in lower-tier partnership A with its other QPIs because the organization indirectly holds 2 percent of the capital and profits interests of lower-tier partnership A (4 percent \times 50 percent). However, the organization may not aggregate its interest in lower-tier partnership B with its QPIs because the organization indirectly holds 5 percent of the capital and profits interests of lower-tier partnership B (10 percent \times

50 percent), which does not meet the requirements of the de minimis test.

(iii) *Designation.* An organization that has a partnership interest meeting the requirements of paragraph (c)(2)(i) or (ii) of this section in a taxable year may designate that partnership interest as a QPI by including its share of partnership gross income (and directly connected deductions) with the gross income (and directly connected deductions) from its other investment activities (see paragraph (c)(1) of this section) in accordance with forms and instructions. Any partnership interest that is designated as a QPI remains a QPI unless and until it no longer meets the requirements of paragraph (c)(2)(i) or (ii) of this section. For example, if an organization designates a directly-held partnership interest that meets the requirements of the de minimis rule as a QPI in one taxable year, the organization cannot, in the next taxable year, use NAICS 2-digit codes to describe the partnership trades or businesses that are unrelated trades or businesses with respect to the organization unless the directly-held partnership interest fails to meet the requirements of both the de minimis test and the control test.

(3) *De minimis test.* A partnership interest is a QPI that meets the requirements of the de minimis test if the organization holds directly (within the meaning of paragraph (c)(2)(i) of this section) or indirectly (within the meaning of paragraph (c)(2)(ii) of this section) no more than 2 percent of the profits interest and no more than 2 percent of the capital interest.

(4) *Control test*—(i) *In general.* A partnership interest is a QPI that meets the requirements of the control test if the organization holds no more than 20 percent of the capital interest and does not control the partnership within the meaning of paragraph (c)(4)(iii) of this section.

(ii) *Combining related interests.* When determining an organization's percentage interest in a partnership for purposes of paragraph (c)(4)(i) of this section, the interests of a supporting organization (as defined in section 509(a)(3) and § 1.509(a)-4) or a controlled entity (as defined in section 512(b)(13)(D) and § 1.512(a)-1(l)) in the same partnership will be taken into account. For example, if an organization owns 10 percent of the capital interests in a partnership, and its supporting organization owns an additional 15 percent capital interest in that partnership, the organization would not meet the requirements of the control test because its aggregate percentage interest

exceeds 20 percent (10 percent + 10 percent = 20 percent).

(iii) *Control.* All facts and circumstances, including the partnership agreement, are relevant for determining whether an organization controls a partnership. In any case, however, an organization controls a partnership if—

(A) The 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;

(B) Any of the organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time;

(C) Any of the organization's officers, directors, trustees, or employees have rights to conduct the partnership's business at any time; or

(D) The organization, by itself, has the power to appoint or remove any of the partnership's officers or employees or a majority of directors.

(5) *Reliance on Schedule K-1 (Form 1065)*—(i) *In general.* When determining the organization's percentage interest (described in paragraph (c)(5)(ii) of this section) in a partnership for purposes of the de minimis test (described in paragraph (c)(3) of this section) and the control test (described in paragraph (c)(4) of this section), an organization may rely on the Schedule K-1 (Form 1065) (or its successor) it receives from the partnership if the form lists the organization's percentage profits interest or its percentage capital interest, or both, at the beginning and end of the year. However, the organization may not rely on the form to the extent that any information about the organization's percentage interest is not specifically provided. For example, if the Schedule K-1 (Form 1065) an organization receives from a partnership lists the organization's profits interest as "variable" but lists its percentage capital interest at the beginning and end of the year, the organization may rely on the form only with respect to its percentage capital interest.

(ii) *Determining percentage interest.* For purposes of paragraph (c)(5)(i) of this section, an organization determines its percentage interest by taking the average of the organization's percentage interest at the beginning and the 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 period of ownership within the partnership's taxable year. For example, if an organization acquires an interest in a partnership that files on a calendar year basis in May and the partnership

reports on Schedule K-1 (Form 1065) that the partner held a 3 percent profits interest at the date of acquisition but held a 1 percent profits interest at the end of the calendar year, the organization will be considered to have held 2 percent of the profits interest in that partnership for that year ((3 percent + 1 percent)/2).

(6) *UBTI from the investment activities of organizations subject to section 512(a)(3)*. For purposes of paragraph (c)(1) of this section, UBTI from the investment activities of an organization subject to section 512(a)(3) includes any amount that—

(i) would be excluded from the calculation of UBTI under section 512(b)(1), (2), (3), or (5) if the organization were subject to section 512(a)(1);

(ii) is attributable to income set aside (and not in excess of the set aside limit described in section 512(a)(3)(E)), but not used, for a purpose described in section 512(a)(3)(B)(i) or (ii); or

(iii) is in excess of the set aside limit described in section 512(a)(3)(E).

(7) *Transition rule for certain partnership interests—(i) In general*. If a directly-held partnership interest acquired prior to August 21, 2018, is not a QPI, an organization may treat such partnership interest as a separate unrelated trade or business for purposes of section 512(a)(6) regardless of the number of unrelated trades or businesses directly or indirectly conducted by the partnership. For example, if an organization has a 35 percent capital interest in a partnership acquired prior to August 21, 2018, it can treat the partnership as a single trade or business even if the partnership's investments generated UBTI from lower-tier partnerships that were engaged in multiple trades or businesses. A partnership interest acquired prior to August 21, 2018, will continue to meet the requirement of this rule even if the organization's percentage interest in such partnership changes before the end of the transition period (see paragraph (c)(7)(iii) of this section).

(ii) *Exclusivity*. An organization may apply either the transition rule in paragraph (c)(7)(i) of this section or the look-through rule in paragraph (c)(2)(ii) of this section, but not both, to a partnership interest described in paragraph (c)(7)(i) of this section that also qualifies for application of the look-through rule described in paragraph (c)(2)(ii).

(iii) *Transition period*. An organization may rely on this transition rule until the first day of the organization's first taxable year beginning after [DATE OF

PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER].

(8) *Limitations—(i) Social clubs*. Paragraphs (c)(2) (regarding QPIs) and (c)(7) (transition rule for certain partnership interests) of this section do not apply to social clubs described in section 501(c)(7).

(ii) *General partnership interests*. Any partnership in which an organization is a general partner is not a QPI within the meaning of paragraph (c)(2) of this section, regardless of the organization's percentage interest.

(iii) *Application of other sections*. This paragraph (c) will not otherwise impact application of section 512(c) and the fragmentation principle under section 513(c).

(d) *Income from certain controlled entities—(1) Specified payments from controlled entities*. If an organization (controlling organization) controls another entity (within the meaning of section 512(b)(13)(D)) (controlled entity), all specified payments (as defined in section 512(b)(13)(C)) received by a controlling organization from that controlled entity will be treated as gross income from a separate unrelated trade or business for purposes of paragraph (a) of this section. If a controlling organization receives specified payments from two different controlled entities, the payments from each controlled entity are treated as a separate unrelated trade or business. For example, a controlling organization that receives rental payments from two controlled entities will have two separate unrelated trades or businesses, one for each controlled entity. The specified payments from a controlled entity will be treated as gross income from one trade or business regardless of whether the controlled entity engages in more than one unrelated trade or business or whether the controlling organization receives more than one type of specified payment from that controlled entity.

(2) *Certain amounts derived from controlled foreign corporations*. All amounts included in UBTI under section 512(b)(17) will be treated as income derived from a separate unrelated trade or business for purposes of paragraph (a) of this section.

(e) *S corporation interests—(1) In general*. Except as provided in paragraph (e)(2) of this section, if an organization owns stock in an S corporation (S corporation interest), such S corporation interest will be treated as an interest in a separate unrelated trade or business for purposes of paragraph (a) of this section. Thus, if an organization owns two S corporation interests, neither of which is described

in paragraph (e)(2) of this section, the exempt organization will report two separate unrelated trades or businesses, one for each S corporation interest. The UBTI from an S corporation interest is the amount described in section 512(e)(1)(B).

(2) *Exception—(i) Qualifying S corporation interest*. Notwithstanding paragraph (e)(1) of this section, an organization may aggregate its UBTI from an S corporation interest with its UBTI from other investment activities (described in paragraph (c)(1) of this section) if the organization's ownership interest (by percentage of stock ownership) in the S corporation meets the criteria for a QPI as described in paragraph (c)(2)(i) of this section (qualifying S corporation interest).

(ii) *Reliance on Schedule K-1 (Form 1120-S)*. When determining how much S corporation stock an organization owns for purposes of paragraph (e)(2)(i) of this section, the organization may rely on the Schedule K-1 (Form 1120-S) (or its successor) it receives from the S corporation if the form lists the organization's percentage of stock ownership for the year.

(f) *Allocation of deductions*. An organization must allocate deductions between separate unrelated trades or businesses using the method described in § 1.512(a)-1(c).

(g) *Total UBTI—(1) In general*. The total UBTI of an organization with more than one unrelated trade or business is the sum of the UBTI computed with respect to each separate unrelated trade or business (as identified under paragraph (a)(2) of this section and subject to the limitation described in paragraph (g)(2) of this section), less a specific deduction under section 512(b)(12).

(2) *UBTI not less than zero*. For purposes of paragraph (g)(1) of this section, the UBTI with respect to any separate unrelated trade or business identified under paragraph (a)(2) of this section cannot be less than zero.

(h) *Net operating losses—(1) In general*. For taxable years beginning after December 31, 2017, an exempt organization with more than one unrelated trade or business determines the NOL deduction allowed by sections 172(a) and 512(b)(6) separately with respect to each of its unrelated trades or businesses. Accordingly, if an exempt organization has more than one unrelated trade or business, § 1.512(b)-1(e) applies separately with respect to each such unrelated trade or business.

(2) *Coordination of pre-2018 and post-2017 NOLs*. An organization with losses arising in a taxable year beginning before January 1, 2018 (pre-2018 NOLs),

and with losses arising in a taxable year beginning after December 31, 2017 (post-2017 NOLs), deducts its pre-2018 NOLs from total UBTI before deducting any post-2017 NOLs with regard to a separate unrelated trade or business against the UBTI from such trade or business. Pre-2018 NOLs are taken against the total UBTI as determined under paragraph (g) of this section in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year.

(i) *Applicability dates.* This section is applicable to taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER].

■ **Par. 6.** Section 1.512(b)–1 is proposed to be amended by:

- 1. Revising paragraph (a)(1).
- 2. Adding a new sentence to the end of paragraph (a)(3).
- 3. Adding a new paragraph (e)(5).
- 4. Adding new paragraphs (g)(4) and (5).

The revisions and additions read as follows:

§ 1.512 (b)–1 Modifications

(a) * * *

(1) * * * Dividends (including an inclusion of subpart F income under section 951(a)(1)(A) or an inclusion of global intangible low-taxed income (GILTI) under section 951A(a), both of which are treated in the same manner as a dividend for purposes of section 512(b)(1)), interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in § 1.837–7 or regulations issued under section 446), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner,

and all deductions directly connected with any of the foregoing items of income must be excluded in computing unrelated business taxable income.

* * * * *

(3) * * * The exclusion under paragraph (a)(1) of this section of an inclusion of subpart F income under section 951(a)(1)(A) or an inclusion of GILTI under section 951A(a) from income (both inclusions being treated in the same manner as dividends) is applicable to taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER]. However, an organization may choose to apply this exclusion to taxable years beginning before [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER].

* * * * *

(e) * * *

(5) See § 1.512(a)–6(h) regarding the computation of the net operating loss deduction when an organization has more than one unrelated trade or business.

* * * * *

(g) * * *

(4) The term *unrelated business taxable income* as used in section 512(b)(10) and (11) refers to unrelated business taxable income after application of section 512(a)(6).

(5) Paragraph (g)(4) of this section is applicable to taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER].

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■ **Par. 7.** Section 1.513–1 is proposed to be amended by:

- 1. Revising the third and fourth sentence in paragraph (a).
- 2. Redesignating paragraphs (f) and (g) as paragraphs (g) and (h).

■ 3. Adding new paragraph (f).

■ 4. Adding a new sentence to the end of new paragraph (h).

The revisions and additions read as follows:

§ 1.513–1 Definition of unrelated trade or business.

(a) * * * For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of *unrelated trade or business* applicable to certain trusts, see paragraph (f) of this section. * * *

* * * * *

(f) *Special definition of “unrelated trade or business” for trusts.* In the case of a trust computing its unrelated business taxable income under section 512 for purposes of section 681, or a trust described in section 401(a) or section 501(c)(17), which is exempt from tax under section 501(a), section 513(b) provides that the term *unrelated trade or business* means any trade or business regularly carried on by such trust or by a partnership of which it is a member. This definition also applies to an individual retirement account described in section 408 that, under section 408(e), is subject to the tax imposed by section 511.

* * * * *

(h) * * * Paragraph (f) of this section applies to taxable years beginning on or after [DATE OF PUBLICATION OF THE FINAL RULES IN THE FEDERAL REGISTER].

* * * * *

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

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