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Alert | Tax-Exempt Organizations

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IRS Issues Proposed Regulations on Tax-Exempt Organization Unrelated Trade or Business Losses; Social Clubs Subject to Special Rules

The IRS has issued proposed regulations addressing the calculation of unrelated business taxable income (UBTI) for purposes of Section 512(a)(6) of the Internal Revenue Code. The proposed regulations contain needed guidance on UBTI provisions enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA).

Code Section 512(a)(6)

Generally, tax-exempt organizations are subject to tax on gross income if the activity that generates the income (i) constitutes a trade or business, (ii) is regularly carried on by the organization, and (iii) the conduct of the activity is not substantially related to the performance of the organization's exempt function (other than the production of funds). Modifications to UBTI exempt certain kinds of passive income such as dividends, interest, and rents from UBTI. The intent is to preclude a tax-exempt organization from avoiding income taxes on non-exempt business activities.

A special definition applies for social clubs, voluntary employees' beneficiary associations (VEBAs), and supplemental unemployment compensation benefits trusts (SUBs). Section 512(a)(3)(A) defines UBTI for these organizations as the gross income (excluding exempt function income), less the deductions that are directly connected with the production of the gross income (excluding exempt function income). UBTI under Section 512(a)(3) is not limited to the gross income derived by a tax-exempt organization from any

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unrelated trade or business regularly conducted by it; instead, any gross income that is not exempt function income (nonexempt function income) is UBTI under Section 512(a)(3).

Prior to TCJA, a tax-exempt organization could net losses incurred in one unrelated trade or business against income from another unrelated trade or business. Therefore, a tax-exempt organization might engage in multiple unrelated businesses, for example advertising and a restaurant, but only pay taxes on the aggregate net income from all the unrelated businesses it engaged in.

TCJA enacted Code Section 512(a)(6), which generally provides that a tax-exempt organization must calculate UBTI separately for each unrelated trade or business carried on by the organization. The Code provision did not define what a "separate" unrelated trade or business was.

Notice 2018-67

The IRS issued interim guidance in Notice 2018-67 (the Notice) on the determination of what constitutes a separate unrelated trade or business. The Notice provided that a tax-exempt organization should use a reasonable, good-faith interpretation of the unrelated trade or business Code provisions, considering all the facts and circumstances. A tax-exempt organization was directed to use the North American Industry Classification System (NAICS) six-digit code in making its determination of when an activity was separate. The Notice did provide that gross income would be aggregated in the case of income from debt-financed properties (investment income from debt financed property is treated as UBTI), income from controlled entities, and "global intangible low-taxed income" (certain income from a controlled foreign corporation).

The Notice aggregated investment activities in certain circumstances (i.e., multi-tiered partnerships). Under this interim rule, a tax-exempt organization may aggregate its UBTI from its interest in a single partnership with multiple trades or businesses, including trades or businesses conducted by lower-tier partnerships, so long as the directly held interest in the partnership meets the requirements of either the de minimis test or the control test. Additionally, under this interim rule, a tax-exempt organization may aggregate all qualifying partnership interests (QPIs) and treat the aggregate group of qualifying partnership interests as comprising a single trade or business. A transition rule treats all partnership interests acquired before Aug. 21, 2018, as a single trade or business. The interim rules and the transition rule do not apply to exempt organizations described in Code Sec. 501(c)(7), social clubs, that are subject to Code Sec. 512(a)(3).

Because of the different applicable definition of UBTI, special rules apply for social clubs, VEBAs, and SUBs. The Notice states that, for example, a social club that receives non-member income from multiple sources, such as from a dining facility and from a retail store, would have more than one unrelated trade or business for purposes of Section 512(a)(6).

Proposed Regulations

On April 24, 2020, the IRS published proposed regulations. The proposed regulations generally follow Notice 2018-67 with some clarifications. The most significant include the following:

Tax-exempt organizations may use a two-digit NAICS designation instead of the six-digit designation to define an unrelated trade or business. The two-digit designation indicates the sector of economic activity of the unrelated trade or business. This change is meant to make the designation process simpler for tax-exempt organizations. Any unrelated business cannot use the same two-digit NAICS designation as the

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organization uses for its exempt function (i.e., a social club cannot use "71" (arts, entertainment, and recreation) to describe its nonmember income).

The same activities in different geographic areas may be aggregated (i.e., separate restaurants) as a single unrelated trade or business. Investment activities may be aggregated as a single unrelated trade or business.

For Section 501(c)(3) organizations, the public support test (Section 509(a)(1) and Section 170(b)(1)(A)) will be determined without consideration of Section 512(a)(6).

Social Clubs

As in Notice 2018-67, because of the definition of UBTI applicable to social clubs described in Section 501(c)(7), social clubs will be required to separate each nonmember activity as a separate unrelated trade or business. The IRS rejected comments that the separation would be administratively difficult. For example, a golf club will be required under the proposed regulations to separate income from green fees, meals, equipment rentals or purchases and facility rentals by nonmembers into separate unrelated businesses. Losses from one of these activities will not offset income from another such activity, even though the revenue may come from the same nonmember on one visit to the club. We anticipate that the bookkeeping involved may be complicated.

In addition, the proposed regulations provide that activities pursued without a profit motive are still unrelated business income that will require the separate computations. Nonrecurring events must be treated as separate activities (e.g., U.S. Open golf tournament).

The separate computation of net income for each non-exempt activity will not impact on the determination if the social club meets the requirement that substantially all of its activities are for exempt purposes. Generally, this is measured by examining the sources of gross receipts, not net income.

Notice 2018-67 provided that the interim and transition rules for certain partnership interests did not apply to social clubs. Section 501(c)(7) defines social clubs and requires that "substantially all of the activities" 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. 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.

Applicability Dates

For taxable years beginning before the date the proposed regulations are published in the *Federal Register* as final regulations, an organization may rely on a reasonable, good-faith interpretation of Code 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). An organization may rely on the proposed regulations in their entirety or it may rely on the guidance in the Notice 2018-67. The IRS is accepting written or electronic comments until 60 days after April 24, 2020.

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Future

The proposed regulations do not address the impact of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) on the use of net operating losses. Guidance on this should be provided by the IRS.

Members of the tax-exempt community have urged Congress to repeal Section 512(a)(6). Similar urging resulted in repeal retroactively of the tax on transportation fringe benefits.

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