DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9933]

RIN 1545–BO79

Unrelated Business Taxable Income Separately Computed for Each Trade or Business

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final rule.

SUMMARY: This document contains final regulations that provide guidance on how an exempt organization subject to the unrelated business income tax determines if it has more than one unrelated trade or business, and, if so, how the exempt organization calculates unrelated business taxable income. The final regulations also clarify that the definition of ''unrelated trade or business'' applies to individual retirement accounts. Additionally, the final 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 determining unrelated business taxable income. The final regulations affect exempt organizations that are subject to the unrelated business income tax.

DATES:

Effective date: The final regulations are effective on December 2, 2020.

Applicability date: For dates of applicability, see §§ 1.170A–9(k)(3), 1.509(a)–3(o), 1.512(a)–1(h), 1.512(a)–6(i), 1.512(b)–1(a)(3), 1.512(b)–1(g)(5), and 1.513–1(h).

FOR FURTHER INFORMATION CONTACT: Jonathan A. Carter at (202) 317–5800 or Stephanie N. Robbins at (202) 317–4086 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) by adding final regulations under section 512(a)(6) of the Internal Revenue Code (Code). Section 512(a)(6) 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). Section 512(a)(6) requires an exempt organization subject to the unrelated business income tax under section 511 (UBIT) that has more than one unrelated trade or business, to calculate unrelated business taxable income (UBTI), separately with respect to each such trade or business including for purposes of determining any net operating loss (NOL) deduction.

In August 2018, the Department of the Treasury (Treasury Department) and the IRS released 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.

On April 24, 2020, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–106864–18) in the **Federal Register** (85 FR 23172) that proposed regulations to provide guidance regarding how an exempt organization subject to UBIT (hereinafter referred to as an exempt organization) determines if it has more than one unrelated trade or business, and, if so, how the exempt organization calculates UBTI under section 512(a)(6) (proposed regulations). No public hearing was requested or held. The Treasury Department and the IRS received 17 comments in response to the proposed regulations.

The proposed regulations reserved two issues for additional consideration. The first issue relates to the allocation of expenses, depreciation, and similar items shared between an exempt activity and an unrelated trade or business or between more than one unrelated trade or business. The second issue relates to changes made to the section 172 NOL deduction by the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136, 134 Stat. 281 (2020) (CARES Act). The Treasury Department and the IRS anticipate publishing a separate notice of proposed rulemaking that will address these issues.

After consideration of the comments received, the proposed regulations are adopted as modified by this Treasury Decision. The major areas of comment and the revisions to the proposed regulations are discussed in the following Summary of Comments and Explanation of Revisions. The comments are available for public inspection at *www.regulations.gov* or on request. Other minor, non-substantive modifications made to the proposed regulations and adopted in these final regulations are not discussed in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

These final regulations provide guidance on how an exempt organization determines if it has more than one unrelated trade or business, and, if so, how the exempt organization calculates UBTI under section 512(a)(6). The final regulations also clarify that the definition of ''unrelated trade or business'' in section 513(b) applies to individual retirement accounts and 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.

1. Separate Unrelated Trade or Business

Consistent with section 512(a)(6) and the proposed regulations, the final regulations provide that an exempt organization with more than one unrelated trade or business must compute UBTI separately with respect to each unrelated trade or business, without regard to the specific deduction in section 512(b)(12), including for purposes of determining any NOL deduction.

a. NAICS 2-Digit Codes Retained

The proposed regulations generally provided that an exempt organization must 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 unrelated trade or business. Most commenters agreed with the proposed regulations' adoption of NAICS 2-digit codes over NAICS 6-digit codes, which Notice 2018–67, for purposes of interim guidance, provided was a reasonable way to identify separate trades or businesses. One commenter discussed how the use of NAICS 2-digit codes balances legislative intent of not allowing the losses from one unrelated trade or business to offset the income from another unrelated trade or business with the need for an administrable and efficient method of identifying separate unrelated trades or businesses. Other commenters agreed that NAICS 2-digit codes offer the most administrable and least burdensome method of identifying separate unrelated trades or businesses for both exempt organizations and the IRS.

One commenter disagreed with the use of NAICS 2-digit codes to identify separate unrelated trades or businesses. This commenter noted that, in passing the TCJA, Congress intended to limit exempt organizations' use of tax benefits that are unrelated to their tax-exempt purpose or purposes, and the commenter asserted that the proposed regulations reversed this congressional intent by identifying separate unrelated trades or businesses using the twenty broad categories provided by NAICS 2-digit codes. This commenter recommended instead that the rules relating to the qualified business deduction under section 199A for identifying a separate trade or business should be used for purposes of section 512(a)(6). The regulations under section 199A provide that the term ''trade or business'' has the same meaning as in section 162. The commenter contended that enough case law exists with respect to section 162 to define ''trade or business'' and that the section 199A regulations have provided practitioners with enough experience to identify a trade or business using this definition.

The final regulations do not adopt the approach taken by the section 199A regulations as a method of identifying separate unrelated trades or businesses for purposes of section 512(a)(6) because, although sections 199A and 512(a)(6) were both enacted as part of the TCJA, they serve different purposes. Section 199A, in part, provides individuals, estates, and certain trusts a deduction of up to 20 percent of business income from certain domestic trades or businesses. Such taxpayers might be engaged in one or more trades or businesses for which they may be entitled to the section 199A deduction. For purposes of computing the section 199A deduction, taxpayers are required to determine the specific lines between trades or business to ensure that only qualified items of income and expense traced to each qualified trade or business are used to compute the deduction and that the W–2 wage and unadjusted basis immediately after acquisition (UBIA) limitations are properly applied. Therefore, the section 199A regulations look to section 162 to determine how these lines should be drawn. By contrast, section 512 looks to section 162 to determine whether a trade or business exists but employs a simplified regime to identify separate unrelated trades or businesses under section 512(a)(6) for exempt organizations because they are not primarily engaged in section 162 for-profit trades or businesses. The regime also applies for a more limited purpose, that is preventing exempt organizations from using losses of one unrelated trade or business to offset the gains of any other unrelated trade or business, and uniformly to all of an exempt organization's separate unrelated trades or businesses. The Treasury Department and IRS believe that using NAICS 2-digit codes in this context provides an objective means to identify separate trades or businesses consistent with Congress's intent without imposing an undue burden on exempt organizations. Accordingly, the final regulations under section 512(a)(6) do not adopt this comment.

b. No Additional Methods of Identifying Separate Unrelated Trades or Businesses

One commenter recommended that NAICS 2-digit codes be used as a safe-harbor and that a facts and circumstances test be applied as the primary method of identifying separate unrelated trades or businesses. This commenter asserted that a facts and circumstances test would be more consistent with other parts of the Code (including the regulations under section 199A) and would provide a more flexible framework for variations in activities across exempt organizations. This commenter proposed considering multiple factors for identifying separate trades or businesses that would include the interdependence of the activities, the geographic location of the activities, and the relationship the exempt organization has with the operation of the activity. The commenter opined that a facts and circumstances test would help alleviate any inequity caused by section 512(a)(6).

As explained both in Notice 2018–67 and the preamble to the proposed regulations, Congress did not provide any explicit criteria for determining whether an exempt organization has ''more than one unrelated trade or business'' or for identifying ''separate'' unrelated trades or businesses for purposes of calculating UBTI in accordance with section 512(a)(6). The Joint Committee on Taxation (JCT) noted 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 (General Explanation). Notice 2018–67 stated that the Treasury Department and the IRS would like to set forth a more administrable method than a facts and circumstances test for identifying separate unrelated trades or businesses. Nonetheless, the Treasury Department and the IRS considered a facts and circumstances test as a method of identifying separate unrelated trades or businesses in response to comments received following the enactment of section 512(a)(6) and again in response to Notice 2018–67. The factors suggested by commenters, and previously considered, generally were derived from other Code provisions, such as sections 132, 162, 183, 414, and 469. However, these Code provisions primarily consider whether an activity is a trade or business and not whether one trade or business is ''separate'' from another. Accordingly, the Treasury Department and the IRS continue to consider these Code provisions, alone or in conjunction with each other, as unhelpful models for identifying separate trades or businesses for purposes of section 512(a)(6).

It continues to be the case that adoption of a facts and circumstances test, as the only identification method or in addition to a safe harbor using NAICS 2-digit codes, would increase the administrative burden on exempt organizations in complying with section 512(a)(6) because a fact-intensive analysis would be required with respect to each unrelated trade or business. Additionally, adoption of a facts and circumstances test would offer exempt organizations less certainty and likely result in inconsistency among exempt organizations conducting more than one unrelated trade or business because of differing approaches exempt organizations would take in applying such a test. Also, a facts and circumstances test would increase the administrative burden on the IRS, which, upon examination, must perform the same fact-intensive analysis with respect to each of the unrelated trades or businesses identified by the exempt organization for purposes of calculating UBTI. Accordingly, the final regulations do not adopt a facts and circumstances test in addition to or in place of NAICS 2-digit codes as a method of identifying separate unrelated trades or businesses for purposes of section 512(a)(6).

c. Identifying the Appropriate NAICS 2-Digit Code

The proposed regulations provided that an exempt organization's separate unrelated trades or businesses are determined based on the applicable NAICS 2-digit code. Before an exempt organization can identify its ''separate'' unrelated trades or businesses, it must first determine whether it regularly carries on unrelated trades or businesses within the meaning of sections 511 through 514. Section 1.513–1(a) clarifies that, unless one of the specific exceptions of section 512 or 513 applies, gross income of an exempt organization is includible in the computation of UBTI if: (1) It is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions. Accordingly, the final regulations provide that an exempt organization determines whether it carries on unrelated trades or businesses by applying sections 511 through 514. Under the final regulations, the exempt organization then identifies its separate unrelated trades or businesses for purposes of section 512(a)(6) using the methods described in the final regulations. With respect to most unrelated trade or business activities, an exempt organization determines whether those activities are separate unrelated trades or businesses for purposes of section 512(a)(6) based on the most accurate NAICS 2-digit codes describing the activities.

Several commenters requested additional guidance regarding how to choose the ''most accurate'' NAICS 2-digit code. These commenters suggested that strict adherence to NAICS 2-digit codes can result in unrelated trade or business activities that the exempt organization considers to be one unrelated trade or business being separated into two or more unrelated trades or businesses. Other commenters requested that aggregation of NAICS 2-digit codes be allowed in certain circumstances. The commenters provided examples of unrelated trade or business activities that they considered to be one unrelated trade or business but that may be identified as more than one unrelated trade or business when using NAICS 2-digit codes.

For example, one commenter stated that an organization operating a gift shop that sells clothing, electronics, and books in a bricks-and-mortar store and online would report those activities under two different NAICS 2-digit codes—one for the sale of clothing and electronics (44) and one for books and online sales (45). Another example provided by a commenter is a museum that provides catering services, valet parking, and personal property rentals as part of a package for special events, such as weddings, held on its premises. The commenter noted that the museum may be required to identify these activities using three different NAICS 2-digit codes—one for catering (72), one for parking (81), and one for rentals (53). The commenter posited that the museum should be able to treat this activity as one trade or business based on a reasonable and common sense understanding of the service provided (hosting an event), rather than the various components of the provided services.

The Treasury Department and the IRS note that NAICS 2-digit codes aggregate trade or business activities into only 20 separate trades or businesses, compared to the more than 1,000 trades or businesses identified at the NAICS 6-digit code level. Like the proposed regulations, the final regulations provide that a separate unrelated trade or business is identified by the NAICS 2-digit code that most accurately describes the exempt organization's trade or business activity. In addition, the final regulations add that this determination is based on the more specific NAICS code, such as at the 6-digit level, that describes the activity that it conducts. The final regulations also state that the descriptions in the current NAICS manual (available at *www.census.gov*) of trades or businesses using more than two digits of the NAICS codes are relevant in this determination. In response to commenter examples, the final regulations incorporate a rule used in NAICS for identifying certain industries [1] and provide that, in the case of the sale of goods, both online and in stores, the separate unrelated trade or business is identified by the goods sold in stores if the same goods generally are sold both online and in stores.

With respect to the museum example, the Treasury Department and the IRS note that income from activities that is appropriately characterized as income from rentals is generally exempt from UBTI under section 512(b)(3). The analysis of whether an activity produces rental income depends, in part, on whether other services are provided by the exempt organization in connection with the possible rental activity (such as providing space for a wedding). To the extent other services are provided, income from the use of space may cease to be rent from real property and instead take on the character of the services provided. *See* § 1.512(b)–1(c)(5). Exempt organizations already need to do this analysis of the facts and circumstances to determine their UBTI. Similarly, whether services provided in connection with hosting an event should be aggregated or not depends on the facts and circumstances, including the language of the contract or contracts, the services provided, who is providing the services, etc. It is possible that the activities could be separate trades or businesses based on the fragmentation rule contained in section 513(c) and § 1.513–1(b) (''[a]ctivities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization'').

Because the NAICS at the 2-digit code level aggregates all trade or business activities into only 20 separate trades or businesses, many trade or business activities that could be considered separate trades or businesses, such as the provision of food or lodging, are already aggregated into broad categories (NAICS code 72 includes both lodging and food services) and therefore treated as one trade or business under the final regulations. Accordingly, if an exempt organization determines that, based on the facts and circumstances, its trade or business activities must be separated into two or more unrelated trades or businesses under NAICS 2-digit codes, the Treasury Department and the IRS view that result as appropriate to achieve the balance of tax administrability and carrying out the purposes of section 512(a)(6). Thus, under the final regulations, if trade or business activities would be best described by different NAICS 2-digit codes, those activities should be identified using different NAICS 2-digit codes and treated as separate unrelated trades or businesses.

In addition, consistent with the proposed regulations, the final regulations continue to provide that the NAICS 2-digit code must identify the separate unrelated trade or business in which the exempt organization engages (directly or indirectly). The NAICS 2-digit code cannot describe 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) or 511(a)(2)(B) cannot use the NAICS 2-digit code for educational services to identify all of 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.

Also consistent with the proposed regulations, the final regulations continue to provide that an organization will report each NAICS 2-digit code only once. The Treasury Department and the IRS note that this rule permits exempt organizations to aggregate trade or business activities that may occur in

[1] The NAICS code for ''Electronic Shopping and Mail-Order Houses'' provides that ''Store retailing or a combination of store retailing and nonstore retailing in the same establishment—are classified in Sector 44–45, Retail Trade, based on the classification of the store portion of the activity.''

different geographic locations. The final regulations include the same example as provided by the proposed regulations—the pharmacies operated in different geographic locations that are one unrelated trade or business for purposes of section 512(a)(6) because the pharmacy trade or business is identified using one NAICS 2-digit code.

d. Changing NAICS 2-Digit Codes

The proposed regulations generally provided that, once an organization has identified a separate unrelated trade or business using a particular NAICS 2-digit code, the organization cannot change the NAICS 2-digit code describing that separate unrelated trade or business unless two requirements are met. First, the exempt organization must show that the NAICS 2-digit code chosen was due to an unintentional error. Second, the exempt organization must show that another NAICS 2-digit code more accurately describes the unrelated trade or business. The preamble to the proposed regulations stated that the instructions to the Form 990–T, ''Exempt Organization Business Income Tax Return,'' would be updated to describe how an exempt organization notifies the IRS of a change in a NAICS 2-digit code due to an unintentional error.

At least one commenter requested clarification regarding what is meant by ''unintentional error.'' Commenters also suggested that the final regulations should include additional circumstances in which exempt organizations can change the NAICS 2-digit code describing a separate unrelated trade or business. Several commenters explained that the nature of a separate unrelated trade or business may change or evolve to the extent that the unrelated trade or business would be more accurately reported under a different NAICS 2-digit code. One commenter likened this shift in trade or business activities to the commencement of a new unrelated trade or business. Accordingly, these commenters recommended that an exempt organization be permitted to change the NAICS 2-digit code identifying a separate unrelated trade or business if a change in the unrelated business activity results in it being better described by a different NAICS 2-digit code. Finally, one commenter requested that a code change be permitted if the exempt organization's tax preparer reasonably believes that an unrelated trade or business activity is more accurately described by a different NAICS 2-digit code.

Several commenters also requested clarification of the process for reporting an erroneous code. One commenter recommended that the instructions to the Form 990–T clarify that an exempt organization should provide such notification to the IRS on the Form 990–T—including an explanation of the change and any necessary supporting information—and that such change would be effective on the first day of the taxable year beginning after the taxable year for which the Form 990–T providing such notification is filed. This commenter also questioned whether reconciliation was required for the prior taxable year or years in which the erroneous code was used and, if so, how an adjustment resulting from such reconciliation would be applied.

In response to these comments, the final regulations remove the restriction on changing NAICS 2-digit codes. Instead, the final regulations require an exempt organization that changes the identification of a separate unrelated trade or business to report the change in the taxable year of the change in accordance with forms and instructions. *See* section 6012(a)(2) and § 1.6012–2(e). The final regulations clarify that a change in identification of a separate unrelated trade or business includes the changed identification of the separate unrelated trade or business with respect to a partnership interest that was incorrectly designated as a qualifying partnership interest (discussed in part 2.b of this Summary of Comments and Explanation of Revisions). To report the change in identification, the final regulations require an organization to provide certain information with respect to each separate unrelated trade or business the identification of which changes: The identification of the separate unrelated trade or business in the previous taxable year, the identification of the separate unrelated trade or business in the current taxable year, and the reason for the change. The Treasury Department and the IRS anticipate that the instructions to the Form 990–T will be revised for taxable years for which the final regulations are effective to provide instructions regarding where and how changes in identification are reported. The effect on NOLs caused by changes of the identification of separate unrelated trades or businesses are discussed in part 6.d of this Summary of Comments and Explanation of Revisions.

e. Transition From NAICS 6-Digit Codes to NAICS 2-Digit Codes

The preamble to the proposed regulations provided that, for taxable years beginning before the date the proposed 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). The preamble to the proposed regulations provided that an exempt organization could rely on the proposed regulations in their entirety or, alternatively, the methods of aggregating or identifying separate trades or businesses provided in Notice 2018–67, which provided that a reasonable, good-faith interpretation included using NAICS 6-digit codes.

One commenter recommended that the final regulations confirm that an exempt organization that reported separate unrelated trades or businesses using NAICS 6-digit codes in taxable years beginning prior to the exempt organization's first taxable year for which the final regulations are effective can reclassify their activities using NAICS 2-digit codes without having to report an unintentional error.

As discussed in the Applicability Dates section of this preamble, these final regulations are applicable to taxable years beginning on or after December 2, 2020. Although an exempt organization may have used NAICS 6-digit codes to identify its separate unrelated trades or businesses in taxable years beginning before this date, the transition from NAICS 6-digit codes to NAICS 2-digit codes does not require the reporting of a code change because the exempt organization will be using the same NAICS code to identify its separate unrelated trades or businesses—just with fewer digits. The move from NAICS 6-digit codes to NAICS 2-digit codes may result in the combination of NOLs if an exempt organization has trade or business activities that would be separate unrelated trades or businesses if identified using NAICS 6-digit codes but would be one unrelated trade or business if identified using NAICS 2-digit codes. An exempt organization may choose, but is not required, to amend Forms 990–T filed prior to December 2, 2020 to report separate unrelated trades or businesses using NAICS 2-digit codes.

f. No De Minimis Exception Provided

The preamble to the proposed regulations discussed one comment with respect to Notice 2018–67 that suggested the Treasury Department and the IRS adopt a de minimis exception for exempt organizations reporting less than $100,000 of gross UBTI. The preamble to the proposed regulations explained that the Treasury Department and the IRS declined to adopt the comment because section 512(a)(6) does not provide discretionary authority for the Treasury Department and the IRS to establish a de minimis exception. Further, the preamble to the proposed regulations explained that, 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.

One commenter on the proposed regulations nonetheless recommended the adoption of a de minimis exception. This commenter proposed that an exempt organization with less than $10,000 of total gross revenues from all unrelated trade or business activities be permitted to treat all its unrelated trades or businesses as one trade or business for purposes of section 512(a)(6). For exempt organizations with more than $10,000 of total gross revenues from all unrelated trade or business activities, the commenter suggested aggregation of all separate unrelated trades or businesses with less than $1,000 of total gross revenues. The commenter reasoned that exempt organizations with less than $10,000 of total gross revenues from unrelated trade or business activities likely lack the resources necessary to comply with section 512(a)(6).

The commenter attempted to refute the argument that the Treasury Department and the IRS lack the authority to promulgate a de minimis exception by noting that the Treasury Department and the IRS already exercised discretion by permitting exempt organizations to treat their activities in the nature of investments as a separate unrelated trade or business for purposes of section 512(a)(6). The commenter cites the JCT General Explanation as confirmation that the Treasury Department and the IRS are authorized to permit the aggregation of separate unrelated trades or businesses.

Permitting the aggregation of certain investment activities is an administrative rule premised on the difficulty an exempt organization partner may experience in certain situations in obtaining the information needed to determine whether the trades or businesses conducted by the partnership are separate unrelated trades or businesses with respect to the exempt organization partner (see part 2 of this Summary of Comments and Explanation of Revisions for a more in depth discussion). By contrast, permitting the aggregation of ''de minimis'' separate unrelated trades or businesses is contrary to the congressional intent of not permitting exempt organizations to offset the losses from one unrelated trade or business with the gains from another, without regard to the amount of the gross receipts in either trade or business. Finally, the concept of a de minimis amount of UBTI is incompatible with the fragmentation rule in section 513(c); § 1.513–1(b). That is, the fragmentation rule requires the identification of unrelated trade or business activities no matter the size.

To the extent that smaller exempt organizations may have difficulty complying with section 512(a)(6), the Treasury Department and the IRS expect that adoption of NAICS 2-digit codes, as opposed to NAICS 6-digit codes, may relieve much of this burden because smaller exempt organizations are unlikely to have numerous unrelated trades or businesses under these final regulations. Furthermore, under § 1.6012–2(e), an exempt organization is required to file Form 990–T only ''if it has gross income, included in computing [UBTI] for such taxable year, of $1,000 or more.'' This filing threshold, which applies regardless of the number of separate unrelated trades or businesses conducted by the exempt organization, serves as a de minimis rule for small exempt organizations. Accordingly, the Treasury Department and the IRS do not adopt this comment in the final regulations for these reasons as well as the reasons cited in the preamble to the proposed regulations.

g. Allocation of Directly Connected Deductions

i. In General

Section 512(a)(1) permits an exempt organization with an unrelated trade or business to take the deductions allowed under chapter 1 of the Code (chapter 1) that are directly connected with the carrying on of such unrelated trade or business. Section 512(a)(3) similarly permits a social club described in section 501(c)(7), a voluntary employees' beneficiary association (VEBA) described in section 501(c)(9), or a supplemental unemployment benefits trust (SUB) described in section 501(c)(17) to take the deductions allowed under chapter 1 that are directly connected with the production of gross income (excluding exempt function income). 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 (reasonable basis standard).

The preamble to the proposed regulations noted that an exempt organization with more than one unrelated trade or business must not only allocate shared expenses among exempt and taxable activities as described in § 1.512(a)–1(c) but also among separate unrelated trades or businesses. Accordingly, the proposed regulations incorporated the existing allocation standard in § 1.512(a)–1(c) for purposes of section 512(a)(6). No comments were received regarding this approach. Accordingly, the final regulations continue to provide that an exempt organization with more than one unrelated trade or business must allocate deductions between separate unrelated trades or businesses using the reasonable basis standard described in § 1.512(a)–1(c).

ii. The Unadjusted Gross-to-Gross Method Unreasonable in Certain Circumstances

The preamble to the proposed regulations did, however, describe the concerns of the Treasury Department and the IRS regarding the administrability of the reasonable basis standard. The preamble to the proposed regulations announced that the Treasury Department and the IRS would continue to consider whether the reasonable basis standard should be retained and announced the intention to publish a separate notice of proposed rulemaking. As an initial matter, however, the proposed regulations stated 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). If a price difference exists between the provision of a good or service to different populations and no adjustment is made, the gross-to-gross ratio may be described as ''unadjusted.''

Several commenters asserted that the unadjusted gross-to-gross method should not be considered unreasonable.

Of these commenters, two stated that the gross-to-gross method can be reasonable if there is no price difference for goods or services provided in related and unrelated activities or if adjustments are made for any price differences. One commenter further argued that no allocation method should be per se unreasonable because what is unreasonable with respect to one set of facts and circumstances may be reasonable with respect to another.

In response to these commenters' recommendations, the final regulations clarify that allocation of expenses, depreciation, and similar items is not reasonable if the cost of providing a good or service in a related and an unrelated activity is substantially the same, but the price charged for that good or service in the unrelated activity is greater than the price charged in the related activity and no adjustment is made to equalize the price difference for purposes of allocating expenses, depreciation, and similar items based on revenue between related and unrelated activities. For example, if a social club described in section 501(c)(7) charges nonmembers a higher price than it charges members for the same good or service, but does not adjust the price of the good or service provided to members for purposes of allocating expenses, depreciation, and similar items attributable to the provision of that good or service, the allocation method is not reasonable.

The Action on Decision (AOD) relating to *Rensselaer Polytechnic Institute* v. *Commissioner* stated that the IRS would not litigate the reasonableness of an allocation method ''until the allocation rules of [§ 1.512(a)–1(c)] are amended.'' 732 F.2d 1058 (2d Cir. 1984), *aff'g* 79 T.C. 967 (1982); AOD 1987–014 (Jun. 18, 1987). The final regulations amend the rules of § 1.512(a)–1(c) and, as discussed in the Applicability Dates section of this preamble, are effective for taxable years beginning on or after December 2, 2020. Accordingly, the IRS rescinds the AOD to the limited extent of any allocation method that fails to equalize price differences between related activities and unrelated trade or business activities for such taxable years. The IRS will continue to refrain from litigating the reasonableness of other allocation methods pending the publication of further guidance, which the Treasury Department and the IRS continue to consider and expect to publish in a separate notice of proposed rulemaking.

2. Activities in the Nature of Investments

The proposed regulations treat an exempt organization's activities in the nature of an investment (investment activities) as a separate trade or business for purposes of section 512(a)(6). Several commenters repeated the suggestion previously made in response to Notice 2018–67 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 preamble to the proposed regulations explained that the Treasury Department and the IRS concluded that the structure and purposes of sections 511 through 514 indicate that an exempt organization's investment activities are an unrelated trade or business for purposes of section 512(a)(6), although certain income from such investment activities (investment income) is excluded from the calculation of UBTI under modifications in section 512(b). The Treasury Department and the IRS also noted that the language of section 512(a)(6)(B) states an organization's total UBTI is the sum of the UBTI computed for each separate unrelated trade or business under section 512(a)(6)(A). To conclude that investment income is not included in the separately computed UBTI under section 512(a)(6)(A) would be to remove such income entirely from UBTI under section 512(a)(6)(B), even when no modification in section 512(b) applies to the income. Nothing in the legislative history or the statute suggests that Congress intended to amend the items of income that are taxable under section 511. Accordingly, the final regulations continue to treat an exempt organization's investment activities that are subject to UBIT as a separate unrelated trade or business for purposes of section 512(a)(6).

a. Exclusive List of Investment Activities

The proposed regulations provided an exclusive list of an exempt organization's investment activities that may be treated as a 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 part 2.b of this Summary of Comments and Explanation of Revisions); (ii) qualifying S corporation interests (see part 3.a of this Summary of Comments and Explanation of Revisions); and (iii) debt-financed properties (see part 2.d of this Summary of Comments and Explanation of Revisions).[2] Although commenters recommended modifications to the rules regarding the individual items included in this list, no commenters objected to the treatment of these items as investment activities. Accordingly, the final regulations adopt the list of investment activities provided in the proposed regulations without change.

Nonetheless, some commenters recommended that this exclusive list be expanded to include specified payments from controlled entities that are included in UBTI under section 512(b)(13) (discussed in part 2.a.i of this Summary of Comments and Explanation of Revisions) and certain amounts from controlled foreign corporations that are included in UBTI under section 512(b)(17) (discussed in part 2.a.ii of this Summary of Comments and Explanation of Revisions).

i. Specified Payments From Controlled Entities

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 also* § 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.

The proposed regulations provided 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 proposed regulations treated the payments from each controlled entity as separate unrelated trades or businesses.

[2] Special rules discussed in part 4 of this Summary of Comments and Explanation of Revisions apply to social clubs described in section 501(c)(7).

Two commenters recommended that income included in UBTI under section 512(b)(13) should be part of the investment activities trade or business under section 512(a)(6). These commenters noted that different fact patterns can produce different tax results because of the interaction between section 512(b)(13) and the debt-financed property rules of section 514. For example, one commenter provided a series of examples in which a wholly owned taxable subsidiary rented space from its exempt organization parent in a debt-financed property owned by the parent.

Section 1.514(b)–1(b)(2)(ii) of the current regulations states that section 514 does not apply to amounts specifically taxable under other provisions of the Code, such as rents and interest from controlled organizations includible pursuant to section 512(b)(13). Thus, if a controlling organization leases debt-financed property to a controlled organization, the amount of rents includible in the controlling organization's UBTI shall first be determined under section 512(b)(13), and only the portion of such rents not taken into account by operation of section 512(b)(13) are taken into account by operation of section 514. *See* § 1.512(b)–1(l)(5)(ii). Because the regulations provide a clear ordering rule that sets section 512(b)(13) income apart from the rules of section 514, section 512(b)(13) taxable income can never be debt-financed investment income.

The Treasury Department and the IRS considered in the preamble to the proposed regulations whether specified payments should be included with an exempt organization's investment activities and concluded that this treatment 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 this purpose, section 512(b)(13)(A) treats specified payments 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).'' Additionally, 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.

Alternatively, if specified payments are not included with an exempt organization's investment activities, these commenters requested that specified payments from any source be treated as one unrelated trade or business for purposes of section 512(a)(6). The commenters asserted that the aggregation of specified payments would reduce the incentive to restructure financial transactions to obtain more favorable tax results. One commenter set out an example in which the UBTI from the separate unrelated trades or businesses for specified payments received from two controlled entities of an exempt organization differed under section 512(b)(13) depending on whether the exempt organization owned both subsidiaries directly or one subsidiary directly and the other subsidiary indirectly through the first subsidiary. The commenter asserted that aggregating the UBTI from all the controlled entities would create the same tax result for all exempt organizations with these facts regardless of the structure of the subsidiaries and the rental payments.

The Treasury Department and the IRS continue to view specified payments as not appropriately characterized as part of an exempt organization's investment activities. Furthermore, because section 512(b)(13) views specified payments as stemming from the trade or business activity of the controlled entity rather than from its investment activities, the Treasury Department and the IRS decline to adopt the suggestion that all specified payments be treated as one unrelated trade or business for purposes of section 512(a)(6). Rather, because section 512(b)(13)(A) provides that specified payments from a controlled entity are income derived from an unrelated trade or business, the final regulations adopt the proposed regulations regarding specified payments without modification.

ii. Certain Amounts From Controlled 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 gross income from 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.

The proposed regulations treated the provision of insurance by all controlled foreign corporations (CFCs) as one trade or business, regardless of whether such insurance income is received from more than one CFC, which is consistent with how NAICS would categorize the provision of insurance (52—Finance and Insurance). However, the proposed regulations did 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 CFC, 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 described in section 512(b)(17) is not attributed to the exempt organization and thus is distinguishable from any commercial-type insurance activity engaged in directly by the exempt organization.

One commenter recommended that amounts included in income under section 512(b)(17) should be part of an exempt organization's investment activities. This commenter questioned the statement in the preamble to the proposed regulation that ''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 is probably not part of the exempt organization's otherwise appropriately characterized investment activities.'' The commenter explained that, with respect to insurance income specifically, the required ownership by United States shareholders for CFC status is reduced to 25 percent from the usual 50 percent. The commenter asserted that an exempt organization shareholder therefore could hold less than a 10 percent interest in a CFC that as a whole is owned by United States shareholders. The commenter stated that the low percentage of ownership necessary to have such amounts included in UBTI should warrant inclusion with an exempt organization's investment activities, based on the similarity to the ownership percentages for qualifying partnership interest status discussed in part 2.b of this Summary of Comments and Explanation of Revisions. However, another commenter recommended retention of the rules in the proposed regulations for amounts included in income under section 512(b)(17).

As explained in the preamble to the proposed regulations, the reasons for not treating amounts included in income under section 512(b)(17) as an exempt organization's investment activities extend beyond the amount of control the exempt organization may have over the CFC. In particular, that preamble explained that 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. *See* section 501(m) (providing 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)). Further, the percentage interest prongs of the qualifying partnership interest rules, discussed in parts 2.b.iii and 2.b.iv.A of this Summary of Comments and Explanation of Revisions, serve as a proxy for an exempt organization's ability to obtain the information necessary to identify the underlying trade or business of the partnership. For amounts included in income under section 512(b)(17), the underlying trade or business is known because the only amounts included are from the insurance activity of the CFC. Thus, the same treatment of income under section 512(b)(17) is not needed for administrative convenience.

Accordingly, the final regulations adopt without change the proposed regulations regarding the treatment of amounts included in UBTI under section 512(b)(17) for purposes of section 512(a)(6).

b. Qualifying Partnership Interests

In general, for exempt organizations, the activities of a partnership are considered the activities of the exempt organization partners.[3] Specifically, section 512(c) states that if a trade or business regularly carried on by a partnership of which an exempt organization is a member is an unrelated trade or business with respect to such organization, such organization shall include its share of the gross income of the partnership in UBTI. However, commenters on both Notice 2018–67 and the proposed regulations explained the difficulty of obtaining information regarding the trade or business activities of lower-tier partnerships. Therefore, as a matter of administrative convenience for both the exempt organization and the IRS, the proposed regulations permitted, but did not require, an exempt organization to aggregate its UBTI from an interest in a partnership with more than one unrelated trade or business (including unrelated trades or businesses conducted by lower-tier partnerships) if it met certain requirements (qualifying partnership interest, or QPI). Additionally, the proposed regulations permitted the aggregation of any QPI with all other QPIs, resulting in the treatment of the aggregate group of QPIs (along with associated debt-financed income under section 514 and qualifying S corporation interests, both discussed in parts 2.d and 3.a, respectively, of this Summary of Comments and Explanation of Revisions) as a single ''investment activities'' trade or business for purposes of section 512(a)(6)(A).

The proposed regulations identified a partnership interest as a QPI if it met the requirements of either the de minimis test (discussed in part 2.b.iii of this Summary of Comments and Explanation of Revisions) or the control test (discussed in part 2.b.iv of this Summary of Comments and Explanation of Revisions). A few commenters recommended alternative or additional tests to identify a QPI. Three commenters suggested that the generally accepted accounting principles (GAAP) codified by the Financial Accounting Standards Board (FASB) should replace the de minimis and the control tests to identify partnership interests as QPIs. These commenters recommended that any interest that is reported as ''fair value'' under these standards should be considered a QPI and included as part of the exempt organization's investment activities. Two other commenters recommended that a partnership that uses an investment manager should be a QPI. For this purpose, one of these commenters recommended defining an investment manager as someone who is either (i) included in a listing of investment managers with the Securities and Exchange Commission (SEC), (ii) in the business of providing investment advice for compensation and manages at least $150 million in client assets, or (iii) has filed a Form D notice with the SEC with respect to the partnership at issue indicating that interests in such partnership are offered under an exemption from SEC registration requirements. Finally, one commenter provided a general list of facts and circumstances that should be considered when determining whether a partnership interest is a QPI, such as whether the exempt organization is a limited partner, whether the exempt organization has the right to be involved in the day-to-day management or operations of the partnership, and whether the exempt organization formed the partnership.

As noted in Notice 2018–67, the purpose of permitting the aggregation of QPIs is to reduce the administrative burden of obtaining information from the partnership regarding the trade or business activities of the partnership in which the exempt organization holds a modest interest, and particularly of lower-tier partnerships under such partnership. As stated in the preamble to the proposed regulations, the percentage interest level for QPIs was intended as a proxy to identify partnership interests in which the exempt organization does not significantly participate. 85 FR at 23180. Taking into account the comments received, the Treasury Department and the IRS have determined that, for purposes of section 512(a)(6), if the percentage interest level indicates that an exempt organization does not significantly participate in a partnership, the exempt organization is not likely to be able to easily obtain the information required to identify the trades or businesses conducted, directly or indirectly, by the partnership that are unrelated trades or businesses with respect to the exempt organization partner.

The recommendations of the commenters regarding alternate or additional methods to determine whether a partnership interest is a QPI do not provide administrable methods for proximately measuring an exempt organization's ability to obtain information about the partnership's trades or businesses. Under GAAP, an exempt organization accounts for a partnership interest using ''fair value'' if it does not control a partnership or have ''significant influence'' in the partnership or if it holds an interest the value of which is ''readily determinable.'' FASB, 2020, ASC par. 958–810–15–4. As discussed in more detail in part 2.b.iv.B of this Summary

[3] *See* sections 512(c), 513(a); § 1.513–1(d)(1) and (2); *Plumstead Theatre Society, Inc.* v. *Commissioner,* 74 T.C. 1324 (1980); 675 F.2d 244 (9th Cir. 1995); *Service Bolt & Nut Co. Profit Sharing Trust* v. *Commissioner,* 724 F.2d 519 (6th Cir.1983), *affg,* 78 T.C. 812 (1982); Rev. Rul. 98–15, 1998–1 C.B. 718.

of Comments and Explanation of Revisions, determining ''significant influence'' under GAAP is substantially similar to determining significant participation under the participation test. By FASB's own admission, however, determining significant influence is not always clear. FASB, 2020, ASC par. 323–10–15–7. Further, whether a partnership interest has a readily determinable value does not indicate whether an exempt organization has access to the information needed to identify trades or businesses conducted by the partnership that are unrelated trades or businesses with respect to the exempt organization partner. The de minimis and control tests provide a substantially similar standard to that found in GAAP that is more objective and that does not include additional factors outside the scope of the QPI test. Additionally, unlike the adoption of NAICS 2-digit codes, adopting GAAP would mean using a set of rules that are maintained and amended frequently by a non-governmental third party. Furthermore, GAAP does not always align with tax standards.

Similarly, the presence of an investment manager does not indicate whether an exempt organization can obtain information to identify separate unrelated trades or businesses conducted by a partnership. In addition, the requirements for being an investment manager, as outlined by the commenter, require reliance on an SEC system that is designed for purposes that do not align with the those of the QPI tests. As a result, the investment manager test does not satisfy the purpose of the QPI tests and the Treasury Department and the IRS do not adopt this suggestion. Finally, the facts and circumstances test suggested by commenters relies on factors that do not tend to relate to the exempt organization's ability to obtain the information from the partnership needed to identify separate unrelated trades or businesses and therefore do not advance the administrative convenience purpose of the QPI test. Accordingly, the Treasury Department and the IRS do not adopt these suggestions as a reliable method for identifying QPIs.

Other commenters suggested the inclusion of all limited partnerships or limited liability companies (LLCs) in which the exempt organization is not a general partner or managing member (regardless of the exempt organization's percentage interest or other participation in the partnership) as QPIs. As discussed in the preamble to the proposed regulations, the Treasury Department and the IRS decline to adopt this standard 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.

Accordingly, the Treasury Department and the IRS do not adopt the recommended alternative or additional methods for identifying a QPI.

i. Designation of a QPI

The proposed regulations provided 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 exempt organization using NAICS 2-digit codes unless and until the partnership interest is no longer a QPI. For example, if an exempt organization has a partnership interest that is a QPI and the exempt organization designates that partnership interest as a QPI on its Form 990–T, the exempt 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 exempt organization using NAICS 2-digit codes. However, if, in a future taxable year, the exempt organization's partnership interest is no longer a QPI, then the exempt organization would be required to identify the trades or businesses of the partnership that are unrelated trades or businesses with respect to the exempt organization using NAICS 2-digit codes. No comments were received regarding this provision. Accordingly, the final regulations adopt the proposed regulations regarding the designation of QPIs without change.

ii. General Partner Prohibition

The proposed regulations clarified that any partnership in which an exempt organization is a general partner is not a QPI, regardless of the exempt organization's percentage interest. One commenter noted that, while related parties are considered for determination of the percentage interest prong of the control test, these same related parties are not considered when determining the general partner status of the exempt organization under the de minimis test or for determining control under the second prong of the control test. Thus, a related entity may be a general partner in or may control the partnership in which an exempt organization has an interest and such control by the related party would not affect the outcome under the proposed regulations.

The Treasury Department and the IRS agree with the commenter that the determination of whether an exempt organization is a general partner should include related organizations. Thus, the final regulations clarify that, if an organization the interest of which must be taken into account when determining the exempt organization's percentage interest for purposes of the first prong of the control test is a general partner in a partnership in which an exempt organization holds an interest, then such interest is not a QPI.

One commenter recommended that the per se prohibition against general partner status for a partnership interest to be a QPI should be extended to status as a managing member of a limited liability company (LLC). The Treasury Department and the IRS agree that the term ''partnership'' includes all entities, including LLCs, treated as partnerships for Federal tax purposes. Accordingly, an interest in an LLC treated as a partnership for Federal tax purposes can be a QPI. However, the rule in the proposed regulations precluding a general partner interest from being a QPI was intended to apply only to interests held by partners classified as general partners under applicable state law. The Treasury Department and the IRS do not believe it is appropriate to expand the per se prohibition to persons classified as managing members under applicable state law without the opportunity for further notice and comment, although managing members are unlikely to satisfy the participation test due to their significant participation in the LLC. Accordingly, the final regulations adopt the proposed regulation with the clarification that general partner status is determined under applicable state law.

iii. De Minimis Test

The proposed regulations provided that a partnership interest is a QPI that meets the requirements of the de minimis test if the exempt organization holds directly or indirectly no more than 2 percent of the profits interest and no more than 2 percent of the capital interest.

One commenter recommended removing the de minimis test. The Treasury Department and the IRS have concluded that the de minimis test reduces administrative burden by establishing a clear limit below which no other factors need to be considered for inclusion of such interest as a part of an exempt organization's investment activities. Therefore, the Treasury

Department and the IRS retain the de minimis test in the final regulations.

One commenter recommended that the percentage interest threshold of the de minimis test should be increased to 5 percent consistent with other sections of the Code and regulations. The commenter notes that, not only have other parts of the Code determined that 5 percent is sufficiently de minimis, but also that increasing the amount from 2 percent to 5 percent would reduce administrative burden by potentially increasing the number of partnership interests that would meet the requirements of the de minimis test.

The Treasury Department and the IRS do not adopt this commenter's suggestion for the following reasons. For purposes of administrative convenience, the de minimis test allows certain partnership investments to be treated as an investment activity and aggregated with other investment activities. Otherwise, as previously discussed in this section of the preamble, section 512(c) mandates that any partnership interest, even a de minimis interest, must be analyzed to determine whether it is an unrelated trade or business with respect to the exempt organization partner and, by extension, how many unrelated trades or businesses for purposes of section 512(a)(6). Accordingly, any exception made in the interest of the administrative convenience of taxpayers must be narrowly tailored to achieving that purpose.

Furthermore, under the control test, partnership interests that exceed 2 percent are QPIs if those interests meet the requirements of the control test (now renamed the participation test, as discussed in part 2.b.iv of this Summary of Comments and Explanation of Revisions). Many exempt organizations with partnership interests between 2 percent and 5 percent should be able to determine, without much additional burden, that they do not significantly participate in the partnership and thus the partnership interest is a QPI; thus, not much additional convenience would be gained for exempt organizations by increasing the de minimis percentage amount from 2 percent to 5 percent. On the other hand, increasing the percentage under which an exempt organization does not have to demonstrate a lack of significant participation to be able to treat the partnership interest as a QPI would extend the administrative convenience exception to identifying the separate unrelated trades or businesses of the partnership (in accord with section 513(c)) farther than necessary and undermine the statutory requirement of section 512(a)(6). Therefore, the final regulations follow the proposed regulations and provide that a partnership interest is a QPI that meets the requirements of the de minimis test if the exempt organization holds, directly or indirectly, no more than 2 percent of the profits interest and no more than 2 percent of the capital interest. Additionally, the final regulations clarify that the exempt organization must meet the percentage interest requirement of the de minimis rule during the exempt organization's taxable year with which or in which the partnership's taxable year ends.

iv. Control Test Renamed the ''Participation Test''

The proposed regulations provided 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 over the partnership. As previously discussed in this section, the QPI tests focus on determining whether an exempt organization significantly participates in a partnership, thereby indicating an ability to obtain the information needed from the partnership to determine whether a trade or business conducted by the partnership is an unrelated trade or business with respect to the exempt organization partner. To better reflect this intent, the control test has been renamed in these final regulations as the ''participation test.'' Accordingly, the final regulations modify the participation test so that a partnership interest is a QPI that meets the requirements of the participation test if the exempt organization (i) directly holds no more than 20 percent of the capital interest; and (ii) does not significantly participate in the partnership.

A. Percentage Interest

Numerous commenters made recommendations regarding the first prong of the control test, most of which recommended increasing the percentage threshold to 50 percent to conform with the definition of control in section 512(b)(13). These commenters noted that the 50 percent threshold for capital interest is more in line with other definitions of control found in the Code. Other commenters suggested that the percentage interest requirement be eliminated entirely because an exempt organization may control a partnership regardless of its percentage interest.

The final regulations retain the 20 percent threshold used in the proposed regulations. As explained in the preamble to the proposed regulations, the percentage interest prong of the control test was intended to identify partnership interests in which the exempt organization does not have the ability to significantly participate in any partnership trade or business and therefore may be considered an investment activity for purposes of section 512(a)(6). Although an exempt organization may not significantly participate in a partnership in which it has more than a 20 percent interest, the Treasury Department and the IRS note that, as an exempt organization's percentage interest in a partnership increases, so too does the exempt organization's ability to obtain the information necessary to identify the trades or businesses conducted by the partnership that are separate unrelated trades or businesses with respect to the exempt organization partner. Thus, the Treasury Department and the IRS have determined that, for purposes of this aspect of the administrative exception for investment activities, a 20 percent capital interest is a threshold below which the exempt organization may not be able to obtain the needed information if it does not otherwise significantly participate.

The preamble to the proposed regulations noted that the 20 percent threshold is consistent with the administrative exception found in the regulations under section 731 for certain investment activities. *See* section 731(c)(3)(C)(i) & § 1.731–2(e). Some commenters noted that this was not a relevant standard because section 731(c)(3)(C)(i) does not define control. Section 731 defines investment partnerships, in part, as any partnership that has never been engaged in a trade or business.

The regulations under section 731(c)(3)(C)(i) identify situations in which the trade or business activities of a lower tier partnership should not be attributed to an upper tier partnership for purposes of determining whether the upper tier partnership is engaged in a trade or business. Similarly, the QPI rules in the proposed regulations seek to determine when the trade or business of a partnership should not be attributed to the exempt organization such that the partnership may be counted as part of an investment activity rather than as the participation in any underlying trade or business. Thus, the purpose of the regulations under section 731 and the QPI rules in the proposed regulations is similar.

The 20 percent capital interest threshold is further supported by the GAAP standard for ''significant influence'' that some commenters recommended as an alternative to the de minimis and participation tests (see parts 2.b.iii and 2.b.iv of this Summary of Comments and Explanation of Revisions). Due to the difficulty of the significant influence determination, GAAP provides that holding 20 percent voting stock in an investee is presumed, without more, to constitute a significant influence. FASB, 2020, ASC par. 323–10–15–8. The 20 percent voting stock standard in GAAP was written for determining whether the investor has ''significant influence'' in a corporation. FASB, 2020, ASC par. 323–10–15–5. For tax purposes, it is common in the Code, when applying corporate standards to partnerships, to substitute ''capital interest'' for ''voting stock.'' *See, e.g.,* sections 4943(c)(3), 6166(b), & 6038(e)(3). Thus, the 20 percent capital interest threshold in the proposed regulations is consistent with FASB's determinations of the percentage interest that represents ''significant influence,'' which is similar to the significant participation standard found in these regulations.

Accordingly, the final regulations retain the 20 percent capital interest threshold provided by the proposed regulations but clarify that the exempt organization must meet the percentage interest requirement for the exempt organization's taxable year with which or in which the partnership's taxable year ends.

No comments were received regarding how an exempt organization determines its percentage interest in a partnership. Therefore, consistent with the proposed regulations and for purposes of both the de minimis test and the participation test, the final regulations continue to provide that an exempt organization determines its percentage interest by taking the average of the exempt 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. However, the final regulations clarify that, for purposes of the de minimis test, an exempt organization's profits interest in a partnership is determined in the same manner as its distributive share of partnership taxable income (see section 704(b) relating to the determination of the distributive share by the income or loss ratio, and §§ 1.704–1 through 1.704–4). For purposes of both the de minimis test and the participation test the final regulations provide that, in the absence of a provision in the partnership agreement, an exempt organization's capital interest in a partnership is determined on the basis of its interest in the assets of the partnership which would be distributable to such organization upon its withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.[4]

B. Definition of ''Significant Participation''

Under the proposed regulations, a partnership interest met the requirements of the control test if the exempt organization holds no more than a 20 percent of the capital interest and does not control the partnership. The proposed regulations provided that all the facts and circumstances are relevant for determining whether an exempt organization controls a partnership. The proposed regulations clarified that the partnership agreement is among the facts and circumstances that may be considered when determining control. The proposed regulations also listed four specific circumstances that evidence control. Two of the circumstances focused on the exempt organization's ability to perform certain actions on its own. Specifically, the proposed regulations provided 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 focused 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.

In essence, the proposed regulations provided a two-part test for determining control: (1) A general facts and circumstances test based on the well-defined concept in the Code of ''control,'' and (2) factors evidencing ''per se'' control. As discussed in the introduction to part 2.b.iv of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have renamed the ''control test'' the ''participation test'' to better capture the purpose of the test, which is to identify partnerships in which exempt organization partners significantly participate. However, unlike ''control,'' ''significant participation'' generally is not a defined term in the Code. A test considering all the facts and circumstances to determine whether an exempt organization partner significantly participates in a partnership could have a broader application than intended. Furthermore, a general facts and circumstances standard for a test that is not well-defined increases uncertainty and, as a result, the administrative burden on exempt organizations and the IRS. Therefore, the final regulations do not include a general facts and circumstances test as part of the significant participation prong of the participation test, but instead retain only the four factors, which, in the final regulations, evidence significant participation rather than control.

Some commenters stated that the list of factors indicating control was too broad. One commenter contended that the factors focusing on whether an officer, director, or employee of an exempt organization has rights to manage the partnership or conduct the business of the partnership should be removed entirely as the presence of these factors does not indicate control by the exempt organization. While the factors identified by this commenter and the factors other commenters characterized as too broad may not always represent control, these factors do indicate when an exempt organization participates in the partnership to an extent that would allow the exempt organization to obtain sufficient information to identify the underlying separate trades or businesses.

Another commenter suggested that the factors listed as indicating control may not always result in control, and thus, the factors listed should create a rebuttable presumption of control rather than being ''per se'' indicators of control. The Treasury Department and the IRS retain the factors listed in the proposed regulations as ''per se'' indicators of significant participation because the QPI rules, including the participation test, are designed to provide administrative convenience for both the IRS and exempt organizations. In this way, firm standards that indicate significant participation allow both the IRS and exempt organizations to have more certainty in the decision whether to include such interests with an exempt organization's investment activities. A rebuttable presumption would introduce more uncertainly, rely more on facts and circumstances, and be

[4] These clarifying rules for determining an exempt organization's partnership interest are consistent with longstanding rules in § 53.4943–3(c)(2) for purposes of a private foundation's determination of whether it has excess business holdings.

more difficult for both the IRS and exempt organizations to administer.

The Treasury Department and the IRS note that the factors provided in the regulations are similar to the factors indicating ''control'' and ''significant influence'' under FASB's codification of GAAP, which several commenters proposed as an alternative test. For partnership interests, GAAP determines that enough control exists to require the consolidation of partnership interests with the investor if the investor has substantive kick-out or participating rights. A kick-out right is the ability of limited partners to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause. FASB, 2020, ASC section 958–810–20. These rights are included, in the proposed regulations, in an exempt organization's ability to require, by itself, the partnership to perform, or prevent the partnership from performing, any act that significantly affects the operations of the partnership.

Further, under GAAP, certain participating rights are considered per se substantive rights and overcome the presumption of control by a general partner. These include:

- Selecting, terminating, and setting the compensation of management responsible for implementing the limited partnership policies and procedures; and
- Establishing operating and capital decisions of the limited partnership, including budgets, in the ordinary course of business. ASC paragraph 958–810–25–22.

These substantive participating rights are similar to an exempt organization's ability to appoint or remove, by itself, any of the partnership's officers or employees or a majority of directors; or its officers, directors, trustees, or employees' rights to conduct the partnership's business at any time, respectively. As such, these substantive participating rights found in GAAP are covered by the four factors listed in the proposed regulations as indicating control (here renamed significant participation).

Additionally, some of the factors relevant to ''significant influence'' included in GAAP are representation on the board, the ability to participate in the policy-making process, and the interchange of managerial personnel. FASB, 2020, ASC par. 323–10–15–6. These factors are also similar to the factors in the proposed regulations, which focus on whether an exempt organization's officers, directors, trustees, or employees have rights to participate on the partnership's board or participate in management of the business. Moreover, the ability to participate in the policy-making process could stem from the investor's ability to require the partnership to perform, or prevent the partnership from performing, any act that significantly affects the operations of the partnership. Consequently, the factors for determining ''significant influence'' under GAAP are also covered by the factors listed in the proposed regulations.

Accordingly, the Treasury Department and the IRS have concluded that the list of factors indicating significant participation (renamed from ''control'' as used in the proposed regulations) is consistent with other standards recommended by commenters for making similar determinations. Therefore, the Treasury Department and the IRS continue to believe that, for purposes of the administrative exception for investment activities, the factors listed in the proposed regulations appropriately identify partnerships in which the exempt organization significantly participates such that it can obtain the information needed to identify the trades or businesses conducted by the partnership that are separate unrelated trades or businesses with respect to the exempt organization.

Commenters pointed out that the exercise of certain rights common to all partners in a partnership may be construed to come within the ambit of the list of factors indicating significant participation. Specifically, these commenters explained that an exempt organization with voting rights equal to those of a large number of other limited partners might be considered to be able to prevent the actions of a partnership if the vote requires a unanimous vote. The Treasury Department and the IRS agree with these commenters that the ability to prevent an action of the partnership due to a unanimous vote requirement or through minority consent rights was not intended to be covered by the proposed regulations. Accordingly, the final regulations modify the proposed regulations' treatment of the ability of an exempt organization, by itself, to prevent a partnership from performing an act as a factor that indicates significant participation. As modified, the final regulations provide that an exempt organization significantly participates in a partnership if—

- The exempt organization, by itself, may require the partnership to perform, or prevent the partnership from performing (other than through a unanimous voting requirement or through minority consent rights), any act that significantly affects the operations of the partnership;
- Any of the exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time;
- Any of the organization's officers, directors, trustees, or employees have rights to conduct the partnership's business at any time; or
- The organization, by itself, has the power to appoint or remove any of the partnership's officers or employees or a majority of directors.

Some commenters recommended that instead of, or in addition to, a list of factors that indicate significant participation, the regulations should provide a list of powers that do not indicate significant participation, such as the ability to remove or replace a fund manager who manages partnership investments, to approve the selection or removal of a general partner, to appoint a member of an advisory board of the partnership, to withdraw from a partnership, or to dissolve or terminate the partnership.

The Treasury Department and the IRS expect that, because the participation test no longer includes a general facts and circumstances test, the need to define actions that do not evidence significant participation is significantly reduced or eliminated. An exempt organization need not consider rights or powers other than the four specifically listed in the participation test when determining whether a partnership interest is a QPI. Accordingly, the Treasury Department and the IRS decline to adopt the suggestion to include a list of powers that do not indicate significant participation.

C. Combining Related Interests

The proposed regulations provided a rule to address situations in which an exempt organization may control a partnership through the aggregation of interests (aggregation rule). The aggregation rule in the proposed regulations applied only for purposes of the control test and not for purposes of the de minimis test. The aggregation rule in the proposed regulations required an exempt organization to consider the interests of supporting organizations (as defined in section 509(a)(3)) and controlled entities (as defined in section 512(b)(13)) in the same partnership. The preamble to the proposed regulations stated that the Treasury Department and the IRS would 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.

A supporting organization is characterized as a Type I, Type II, or Type III supporting organization depending on its relationship with its supported organization. The supporting organization may be (i) operated, supervised, or controlled by (Type I), (ii) supervised or controlled in connection with (Type II), or (iii) operated in connection with (Type III), its supported organization.

For a Type I relationship to exist, a supported organization must have a substantial degree of direction over the policies, programs, and activities of its supporting organization. The relationship of the supported organization to the Type I supporting organization is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization.

For a Type II relationship to exist, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to ensure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. The relationship of the supported organization to the Type II supporting organization is comparable to that of a brother and sister, where the supporting organization and the supported organization are subject to common control. *Polm Family Foundation, Inc.* v. *United States,* 655 F. Supp. 2d 125, 128 (D.C. Cir. 2009) (quoting *Cockerline Memorial Fund* v. *Commissioner,* 86 T.C. 53, 59 (1986)).

For a Type III relationship to exist, a supporting organization must, among other things, maintain significant involvement in the operations of a supported organization or provide support on which the supported organization is dependent. A Type III supporting organization can either be functionally integrated or non-functionally integrated. A functionally integrated Type III supporting organization can support its supported organization through engaging in activities substantially all of which directly further the exempt purposes of the supported organization, being the parent of the supported organization, or by supporting certain types of governmental supported organizations. A functionally integrated Type III supporting organization is a parent of the supported organization if the supporting organization exercises a substantial degree of direction over the policies, programs, and activities of the supported organization and a majority of the officers, directors, or trustees of the supported organization is appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacity) of the supporting organization. A non-functionally integrated Type III supporting organization provides financial support to the supported organization that meets the distribution requirements found in § 1.509(a)–4(i)(5)(ii).

Two commenters addressed whether partnership interests of related supporting organizations should be considered in determining the supported organization's percentage interest for purposes of determining whether the supported organization meets the control test. One commenter recommended that none of the partnership interests of a supporting organization should be considered when determining the supported organization's percentage interest. Another made the same recommendation but only with respect to Type III supporting organizations.

An exempt organization with more than one unrelated trade or business may be a supporting organization or a supported organization. If the exempt organization is a supported organization, the exempt organization, or individuals that control the exempt organization, may control the investment activities (including any partnership interests) of its Type I or Type II supporting organizations due to the parent/subsidiary relationship required for a Type I relationship to exist or the brother/sister relationship required for a Type II relationship to exist. In any event, these close relationships increase the likelihood that the exempt organization can obtain the information about its Type I or Type II supporting organization's partnership investments and that the exempt organization significantly participates in the partnership, even if indirectly. Accordingly, the final regulations continue to require an exempt organization that is a supported organization to include the partnership interests of its Type I or II supporting organizations when determining whether its partnership interests of the supported organization meet the percentage interest threshold of the participation test.

On the other hand, in the case of a Type III supporting organization, the exempt organization that is a supported organization is required to have a ''significant voice'' in the investment policies of its Type III supporting organization; nevertheless, depending on the basis for this Type III relationship, this relationship may not permit the supported organization to obtain detailed information regarding its Type III supporting organization's partnership interests or to significantly participate in the partnership. In the case of a Type III supporting organization that is the parent of its supported organizations, the relationship between the supported and supporting organizations is similar to that of a Type I supporting organization, except the supporting organization controls the supported organizations instead of the opposite. Due to this close relationship, the final regulations continue to require the aggregation of partnership interests held by a Type III supporting organization that is the parent of its supported organizations for the purposes of determining whether the supported organization's partnership interest meets the percentage interest threshold of the participation test. However, the interests held by nonparent Type III supporting organizations are not so aggregated.

One commenter recommended adding additional interests to the list of related interests that must be considered when determining percentage interest for purposes of the control test. This commenter recommended including related persons within the definition of section 267(b)(9) and ''controlled taxpayers'' within the principles of section 482 to the list of organizations with which partnership interests must be aggregated. The same commenter also recommended adding indirect interests owned by an exempt organization for the purposes of determining the organization's percentage interest.

As mentioned previously, the QPI rules were created to reduce the administrative burden of obtaining the information needed to determine whether trades or businesses conducted—directly or indirectly—by the partnership are separate unrelated trades or businesses with respect to the exempt organization partner. The addition of the interests recommended to be included by this commenter would significantly increase the administrative burden of the rule but would not necessarily capture interests that demonstrate an increased ability for the exempt organization to obtain the information needed to identify separate underlying trades or businesses. Accordingly, the Treasury Department and the IRS do not adopt these recommended additions to the aggregation rule. Accordingly, the final regulations provide that, when determining an organization's percentage interest for purposes of the participation test (formerly the control test), the interests of a supporting organization (other than a Type III supporting organization that is not a parent of its supported organizations) or a controlled entity in the same partnership are taken into account.

v. Look-Through Rule

The proposed regulations provided that, if an exempt organization does not control a partnership in which the exempt organization holds a direct interest (directly-held partnership interest) but the 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 permitted (but did not require) an exempt organization to aggregate the UBTI from de minimis indirectly-held QPIs with its directly-held QPIs. However, the proposed look-through rule did not apply to indirectly-held QPIs that do not meet the requirements of the de minimis test but might meet the requirements of the control test (now renamed participation test).

Several commenters recommended expanding the look-through rule to permit use of the control test for indirectly-held partnership interests and to permit use of the look-through rule even if the exempt organization controls the directly-held partnership. These commenters stated that, even if an exempt organization controls a directly-held partnership, if the lower-tier partnerships meet the de minimis test or the control test, an exempt organization would be prevented from controlling the lower-tier partnerships. Further, the commenters noted that, preventing the use of such look-through rules would treat organizations holding the same level and type of partnership interests differently depending on whether they owned them directly or indirectly. Another commenter, however, stated that the look-through rule is unhelpful and that it is extremely difficult, if not impossible, to determine ownership percentages in lower-tier partnerships, especially multiple tiers down.

Based on these comments, the final regulations do not prevent application of the look-through rule if the exempt organization significantly participates in the directly-held partnership. The final regulations otherwise retain the look-through rule for indirectly-held partnership interests that meet the requirements of the de minimis test with regard to the exempt organization. Additionally, the final regulations expand application of the look-through rule to indirectly-held partnership interests that meet the requirements of the participation test with regards to the immediately higher-tier partnership that owns interest in that partnership. Thus, for purposes of the look-through rule, the participation test will apply tier-by-tier to the exempt organization's indirectly-held partnership interests. The regulations explain how the second prong of the participation test—the significant participation prong—applies within this context and provides an example of the application of this test.

vi. Grace Period

The preamble to the proposed regulations stated that 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. The Treasury Department and the IRS requested comments regarding whether a higher percentage interest should be permitted in taxable years in which the increase occurs as the result of the actions of other partners.

One commenter stated that private investment funds often admit limited partners in waves (''closings'') over the course of several months at the beginning of the fund's term. Therefore, the commenter recommended a phase-in period that would provide that the percentage interest in a newly formed partnership not be considered for purposes of the control test until the end of the partnership's initial closing period (as long as that period is no later than 18 months following the exempt organization becoming a partner). The final regulations do not adopt an initial phase-in period because the aggregation of an exempt organization's investment activities, including QPIs, is a rule of administrative convenience and a phase-in rule would increase the complexity of the rule. Additionally, as discussed in part 2.b.iv.A of this Summary of Comments and Explanation of Revisions, the final regulations adopt, without change, the rule that an exempt organization's percentage partnership interest is determined by averaging the exempt organization's percentage partnership interest at the beginning of the partnership's taxable year with its partnership percentage interest at the end of that same taxable year. Thus, an exempt organization's percentage interest may vary during a period but still meet the requirements of the participation test.

The commenter also recommended that an exempt organization be granted 90 days to reduce its interest in a partnership to the appropriate amount should its interest exceed that amount at the end of the year through the actions of other partners. Two other commenters recommended that an exempt organization should be permitted to count a partnership interest that exceeds the percentage interest threshold of the participation test due to the actions of other partners as a QPI for a period of time following that change in interest amount. One of the commenters recommended that such interests should be permitted to be QPIs through the end of the tax year in which it learns that the percentage interest exceeds the permitted threshold. The other commenter recommended that such interest should continue to be QPI through the later of (1) the end of the tax year immediately following the year an increase occurs through no fault of the E.O.; or (2) 120 days after the date on which the partnership issues the Schedule K–1.

The Treasury Department and the IRS agree that a change in an exempt organization's percentage interest in a partnership that is due entirely to the actions of other partners may present significant difficulties for the exempt organization. Further, requiring such an interest to be removed from the exempt organization's investment activities in one year but potentially included as a QPI in the next would create further administrative difficulty. Accordingly, the final regulations adopt a grace period that permits a partnership interest to be treated as meeting the requirements of the de minimis test or the participation test, respectively, in the exempt organization's prior taxable year if certain requirements are met.

The final regulations provide that a partnership interest that fails to meet the requirements of either the de minimis test or the participation test because of an increase in percentage interest in the organization's current taxable year may be treated as meeting the requirements of the test it met in the prior taxable year for the taxable year of the change if: (1) The partnership interest met the requirements of the de minimis test or participation test, respectively, in the organization's prior taxable year without application of the grace period; (2) the increase in percentage interest is due to the actions of one or more partners other than the exempt organization; and (3) in the case of a partnership interest that met the requirements of the participation test in the prior taxable year, the interest of the partner or partners that caused the increase in percentage interest described in (2) was not combined for the prior taxable year and is not combined for the taxable year of the change with the exempt organization's partnership interest under the rules discussed in part 2.b.iv.C of this Summary of Comments and Explanation of Revisions. An exempt organization can treat such interest as a QPI in the taxable year that such change occurs, but the exempt organization would need to reduce its percentage interest prior to the end of the following taxable year to meet the requirements of either the de minimis test or the participation test in that succeeding taxable year for the partnership interest to remain a QPI.

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

The proposed regulations provided that, when determining an exempt organization's percentage interest for purposes of the de minimis test or the control test (now renamed the participation test), the exempt organization may rely on the Schedule K–1 (Form 1065) it receives from the partnership 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 clarified that 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 exempt 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. Generally, this information can be found in Part II, line J (partner's share of profit, loss, and capital), of Schedule K–1 (Form 1065). No comments were received with respect to reliance on the Schedule K–1 (Form 1065). Accordingly, the final regulations adopt these proposed regulations without change, other than minor edits for clarity.

Nonetheless, commenters made recommendations with respect to other aspects of the Schedule K–1 (Form 1065) and other partnership or S corporation forms. A few commenters recommended that updates be made to the regulations under section 6031 or on the forms and instructions of the Form 1065, ''U.S. Return of Partnership Income,'' or Form 1120–S, ''U.S. Income Tax Return for an S Corporation,'' including the respective Schedules K–1 provided to partners or S corporation shareholders. These commenters requested updates that would require partnerships to provide information to exempt organization partners (1) on the NAICS 2-digit codes of the underlying activity, (2) separately reporting debt-financed income, and (3) requiring a specific capital interest amount rather than stating ''various.'' Alternatively, another commenter specifically recommended that partnerships not be required to provide the NAICS 2-digit code of the underlying activity.

Section 6031(d) provides that partnerships must provide exempt organization partners with such information as is necessary to enable each partner to compute its distributive share of partnership income or loss from such trade or business in accordance with section 512(a)(1). Following the passage of section 512(a)(6), exempt organization partners will need additional information to compute their UBTI from partnerships under section 512(a)(1). The Treasury Department and the IRS have concluded that the requirement found in section 6031(d) is sufficient for requiring partnerships to provide this information. Accordingly, the Treasury Department and the IRS do not adopt any regulatory changes under section 6031 at this time. The IRS may amend the forms and instructions in the future, however.

viii. Additional Recommended Changes

A. Capital Account Threshold

One commenter recommended that a capital accounts threshold be added to the control test. The commenter recommended that the threshold be based on the average capital account amount throughout the year and that the threshold be $500,000. A capital account threshold does not further the purposes of the QPI tests. A capital accounts threshold added to the control test provided by the proposed regulations (now renamed the participation test) is not an effective proxy for an exempt organization's ability to obtain information from a partnership because the size of a capital account has no correlation to a partner's ability to participate in a partnership. Further, capital accounts can be calculated under various standards, which would result in an inconsistent application of such a rule. Additionally, if the commenter's level of $500,000 capital accounts were accepted, IRS data for the 2018 taxable year indicates that it would encompass over 75 percent of all partnerships held by exempt organizations. Such a threshold therefore likely would not serve as an additional limitation on the ability to use the participation test. Accordingly, the Treasury Department and the IRS do not adopt a capital accounts threshold as part of the participation test.

B. ERISA-Covered Trusts

One commenter recommended that QPI treatment be extended to all partnership interests held by trusts that are subject to the Employee Retirement Income Security Act of 1974, Public Law 93–406, 88 Stat. 829 (1974) (ERISA). The commenter stated that because the fiduciary duty and prohibited transaction rules under ERISA would make it difficult to operate a trade or business through the trust itself, or through an entity that is treated under ERISA as holding ''plan assets'' subject to ERISA, the primary source of UBTI for these plans is investment vehicles that are taxed as partnerships. In addition, the fiduciary and prohibited transaction rules (and related penalties) create an incentive for the investment vehicles to limit the participation of ERISA plans. If 25 percent or more of the value of any class of equity interests in a private investment fund is held by benefit plan investors, the plan assets of a benefit plan investor will generally include not only the plan's investment, but also an undivided interest in each of the underlying assets of the investment fund. Anyone who exercises authority or control with respect to the disposition of plan assets or who provides investment advice with respect to those assets will be a fiduciary of the investing plan. *See* 29 CFR 2510.3–101. Many investment funds seek to avoid this status by limiting ERISA plan investment or qualifying for an exemption. The commenter posited that under the proposed regulations, significant administration would be required to separate investments between QPIs and other partnerships that may be subject to the look-through rule or NAICS codes, and in which the ultimate, bottom-tier investments are almost certainly under the 2 percent ownership threshold for the de minimis test.

To the extent that ERISA-covered trusts' interests in partnerships meet either the de minimis or the participation tests, then those interests will be treated as investment activities. To the extent that the partnership interests of ERISA-covered trusts do not meet the de minimis or the participation test, nothing about ERISA-covered trusts suggests that they are in greater need of the administrative convenience provided by such tests. Consequently, the Treasury Department and the IRS do not adopt this recommendation.

C. Anti-Abuse Rule

One commenter noted that an exempt organization with a directly-held partnership interest in a partnership that is not a QPI (non-QPI partnership) could also have one or more indirectly-held partnership interests in that same partnership through interests that are QPIs (QPI partnerships), which would effectively permit the exempt organization to significantly participate in a partnership but structure its partnership interest such that most of the distributable share of the partnership's income, losses, etc. would be aggregated with its other investment activities. The commenter recommended requiring an exempt organization receiving income through a QPI partnership that derives income from a non-QPI interest in the same partnership to segregate that income from the ''investment activities'' trade or business and report it separately for each underlying trade or business.

Under the situation described by the commenter, an exempt organization's indirectly-held partnership interest (through a QPI partnership) in the non-QPI partnership would necessarily be limited by the fact that the exempt organization may own no more than 20 percent of the QPI partnership and the exempt organization cannot control the QPI partnership; therefore it would be difficult, and perhaps unlikely, for an exempt organization to actively arrange such a scenario for the purposes of avoiding the application of section 512(a)(6). Further, the application of such rule would reduce the administrative convenience that these rules seek to achieve. Accordingly, the Treasury Department and the IRS do not adopt the recommendation.

The same commenter, noting that such a rule would reduce the administrative burden of the QPI rules, recommended the creation of an anti-abuse rule in the alternative. The Treasury Department and the IRS recognize that some situations, similar to the situation posited by the commenter or otherwise, may exist whereby an exempt organization may arrange partnership structures to avoid application of section 512(a)(6). It is always the case that, upon examination, the IRS may determine whether partnership interests are QPIs under the application of the law to the facts and characterize such interests accordingly. Accordingly, the Treasury Department and the IRS do not consider a specific anti-abuse rule necessary for purposes of the QPI rules and the final regulations do not incorporate this comment.

c. Transition Rule

Both Notice 2018–67 and the proposed regulations permitted an exempt organization to treat each partnership interest acquired prior to August 21, 2018, that met the requirements of neither the de minimis test nor 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 (transition rule). This transition rule was proposed to apply until the first day of the organization's first taxable year beginning after the date the proposed regulations are published as final regulations (transition period). The proposed regulations clarified 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. Further, the proposed regulations provided 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.

Three commenters recommended that the transition rule become a grandfather rule such that any partnership interest meeting the requirements of the transition rule would be a single unrelated trade or business in perpetuity for purposes of section 512(a)(6). One commenter stated that the rationale for the transition rule outlined in Notice 2018–67 that ''[a] previously acquired partnership interest may be difficult to modify to the de minimis test or control test and the exempt organization may have to incur significant transaction costs to do so'' will continue to be an accurate reflection of the difficulty of transitioning such previously owned partnership interests even after the final regulations are published.

Changing the transition rule to a grandfather rule is contrary to the congressional intent of section 512(a)(6) to prevent losses of one unrelated trade or business from offsetting gains of another unrelated trade or business. Exempt organizations have been on notice since the announcement of the transition rule in Notice 2018–67 that the transition rule would sunset after publication of final regulations and have had over two years since the release of Notice 2018–67 to anticipate the requirement to account for the income from such partnership interests differently. The Treasury Department and the IRS disagree that the rationale for the transition rule justifies perpetually excluding previously held partnership interests from the application of section 512(a)(6) to the unrelated trade or business activities of the partnership. Accordingly, the Treasury Department and the IRS do not adopt the transition rule as a grandfather rule.

d. Unrelated Debt-Financed Income

The proposed regulations included unrelated debt-financed property or properties described in sections 512(b)(4) and 514 in the list of ''investment activities'' treated as a separate unrelated trade or business for purposes of section 512(a)(6). One commenter recommended that the reference to the definition of debt-financed property ''within the meaning of section 514'' exclude section 514(b)(1)(B) because that paragraph removes from the definition of debt-financed property any property that is used in the production of income from an unrelated trade or business and proposed § 1.512(a)–6(c)(1)(iii) includes income from debt-financed property in the ''investment activities trade or business.'' The commenter further recommended that ''debt-financed property'' exclude debt-financed property used in the production of income from an unrelated trade or business that is reported under a NAICS two-digit code by the exempt organization. Two other commenters recommended allowing exempt organizations to opt out of inclusion of debt-financed property as part of an exempt organization's investment activities and to instead include that income as part of a separate unrelated trade or business identified by the relevant NAICS 2-digit code.

Section 512(b)(4) includes as UBTI any unrelated debt-financed income as defined in section 514. As part of the definition of debt-financed property, section 514(b)(1)(B) provides that ''any property [is not debt-financed 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'' without application of section 512(b)(4). For example, if an exempt organization runs a hotel, but it has taken out a loan to acquire the hotel, then the income from the hotel is UBTI regardless of section 512(b)(4) and the hotel is not ''debt-financed property.'' Sections 1.512(b)–1(c)(5) and 1.514(b)–1(b)(2)(ii). Thus, the income from the hotel is not ''debt-financed income.'' As a result, any income included in UBTI as ''debt-financed income'' necessarily derives from an activity that has otherwise been excluded from the definition of UBTI in section 512(a)(1), for reasons other than the exempt nature of the activity. Section 514 taxes otherwise nontaxable income, derived from leveraged income-producing assets, that are not related to an organization's exempt purposes. Debt-financed income is, therefore, of a different nature than income that is otherwise described in section 512(a)(1) and is more appropriately classified as investment rather than being tied to an underlying trade or business or NAICS 2-digit code.

Furthermore, allowing an exempt organization to elect to treat the debt-financed income as part of a 2-digit NAICS code, instead of including such income as part of an organization's investment activities, would not reduce the burden upon the exempt organization or the burden on the IRS. Such income would still need to be identified as debt-financed income and an additional determination of the underlying activity would also need to be made to determine a 2-digit NAICS code. Furthermore, the inconsistent treatment of debt-financed income by different exempt organizations would increase the administrative burden for the IRS.

Accordingly, the Treasury Department and the IRS adopt the proposed regulation regarding the treatment of debt-financed income without change.

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

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 (as described in section 1361(c)(2)(A)(vi) or (6)) 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.

a. Qualifying S Corporation Interests

As discussed in part 2.a.i of this Summary of Comments and Explanation of Revisions, the proposed and final regulations include qualifying S corporation interests (QSI) in an exempt organization's investment activities. The proposed regulations explained that an S corporation interest is a QSI if the exempt organization's ownership interest (by percentage of stock ownership) in the S corporation meets the requirements for a QPI—that is, the requirements of either the de minimis test or the control test (now renamed the participation test).

The final regulations provide greater clarity regarding how the QPI rules apply to S corporation interests. First, the final regulations provide a number of term substitutions. Specifically, the final regulations provide that, when applying the QPI rules to an S corporation interest, ''S corporation'' is substituted for ''partnership'' and ''shareholder'' or ''shareholders'' is substituted for ''partner'' or ''partners.'' When applying the de minimis test, ''no more than 2 percent of stock ownership'' is substituted for ''no more than 2 percent of the profits interest and no more than 2 percent of the capital interest'' and, when applying the participation test, ''no more than 20 percent of stock ownership'' is substituted for ''no more than 20 percent of the capital interest.'' When applying the reliance rule, ''Schedule K–1 (Form 1120–S)'' is substituted for ''Schedule K–1 (Form 1065).''

Second, the final regulations clarify that the rules regarding the determination of an exempt organization's capital interest and profits interest in a partnership do not apply for purposes of determining whether an S corporation interest is a QSI. Rather, the average percentage stock ownership is determinative.

Third, because of differences in the Schedule K–1 (Form 1065) and the Schedule K–1 (Form 1120–S), the final regulations clarify that an exempt organization can rely on the Schedule K–1 (Form 1120S) received from the S corporation if the form lists information sufficient to determine the exempt organization's percentage of stock ownership for the year. A Schedule K–1 (Form 1120–S) that reports ''zero'' as the organization's number of shares of stock in either the beginning or end of the S corporation's taxable year does not list information sufficient to determine the organization's percentage of stock ownership for the year. The Treasury Department and the IRS are considering whether revision of Schedule K–1 (Form 1120S) is needed to provide the information needed to determine whether an S corporation interest is a QSI.

Finally, the final regulations also clarify that a grace period may apply for changes in an exempt organization's percentage of stock ownership in an S corporation.

b. Nonqualifying S Corporation Interests

With the exception of QSIs, the proposed regulations applied the language of section 512(e)(1)(A) to provide that if an exempt organization owns stock in an S corporation, such S corporation interest will be treated as an interest in a separate unrelated trade or business for purposes of the proposed regulations. Similarly, the proposed regulations clarified that if an exempt organization owns two S corporation interests, neither of which is a QSI, the exempt organization will report two separate unrelated trades or businesses, one for each S corporation interest. The proposed regulations also provided 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 or loss on the disposition of S corporation stock.

Two commenters recommended that an exempt organization with an S corporation interest should be permitted to look through that S corporation to the underlying trades or businesses and to classify those S corporation trades or business using NAICS 2-digit codes. One of these commenters suggested that this should be the general rule for all non-qualifying S corporation interests. The other commenter provided that such a rule should be an alternative to the rule requiring each S corporation interest to be treated as an interest in a separate unrelated trade or business. One of these commenters further recommended that income that would ordinarily be excluded under section 512(b)(1), (2), (3) or (5), but that is taxable because it is earned through an S corporation, should be included as part of the exempt organization's investment activities.

The final regulations adopt the proposed regulations regarding non-qualifying S corporation interests without change. As discussed in the preamble to the proposed regulations, this treatment is consistent with the language of section 512(e)(1)(A), which treats an interest in an S corporation as an unrelated trade or business. Although the Treasury Department and the IRS considered whether to permit exempt organizations to look through the S-corporation and identify the separate unrelated trades or businesses conducted by the S-corporation using NAICS 2-digit codes as a matter of administrative convenience, the commenters to Notice 2018–67 noted that obtaining that information from the S corporation would be difficult. Accordingly, the Treasury Department and the IRS decline to adopt a rule that modifies the straightforward application of the language of section 512(e)(1)(A) and is not otherwise justified as a matter of administrative convenience to taxpayers or the IRS.

4. Social Clubs, Voluntary Employees' Beneficiary Associations, and Supplemental Unemployment Benefits Trusts

As discussed in the preamble to the proposed regulations, section 512(a)(3) provides a special definition of UBTI for social clubs, VEBAs, and SUBs.[5] Unlike an exempt organization subject to section 512(a)(1) which is taxed only on income derived from an unrelated trade or business, a social club, VEBA, or SUB is taxed on ''gross income (excluding exempt function income),'' which includes amounts excluded from the calculation of UBTI under section 512(a)(1), such as interest, annuities, dividends, royalties, rents, and capital gains. The preamble to the proposed regulations provided that, despite the differences between section 512(a)(1) and (3), a social club, VEBA, or SUB would 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). The final regulations adopt the same approach, as discussed in parts 4.a and b of this Summary of Comments and Explanation of Revisions.

a. Investment Activities

As discussed in part 2 of this Summary of Comments and Explanation of Revisions, the proposed regulations treated certain investment activities (that is, QPIs, QSIs, and debt-financed property or properties) as a separate unrelated trade or business for purposes of section 512(a)(6). Thus, because a social club, VEBA, or SUB determines whether it has more than one unrelated trade or business in the same manner as an exempt organization subject to section 512(a)(1), such an exempt organization would include the investment activities specifically listed in the proposed regulations as a separate unrelated trade or business for purposes of section 512(a)(6). However, because UBTI is defined differently for social clubs, VEBAs, and SUBs, the proposed regulations clarified 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 any amount that (i) would be excluded from the calculation of UBTI under section 512(b)(1), (2), (3), or (5) (that is, interest, annuities, dividends, royalties, rents, and capital gains) 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). The final regulations adopt the proposed investment activity rules specific to social clubs, VEBAs, and SUBs, without change as discussed in part 4.a.i and ii of this Summary of Comments and Explanation of Revisions.

In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on any unintended consequences, in areas other than UBIT, resulting from the treatment of investment activity of VEBAs and SUBs as an unrelated trade or business for purposes of section 512(a)(6). One commenter expressed a concern that these proposed rules could encourage VEBAs and SUBs to create more complicated investment structures (for example, increased use of blocker corporations) or that these rules could encourage VEBAs and SUBs to consider more conservative investment strategies than otherwise merited based on their asset values.

The commenter did not include any further elaboration on these general nontax concerns regarding the investment behavior of VEBAs and SUBs. Furthermore, the commenter did not offer a specific recommendation to address these general concerns other than its overall recommendation to not treat investment activities as an unrelated trade or business for purposes of section 512(a)(6). As discussed earlier in part 2 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have concluded that the structure and purposes of sections 511 through 514 treat an exempt organization's investment activities as unrelated trade or business activities for purposes of section 512(a)(6). Accordingly, the final regulations adopt these provisions of the proposed regulations without change.

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

Social clubs, VEBAs, and SUBs generally must include interest, dividends, royalties, rents, and capital gains in UBTI under section 512(a)(3)(A) because the modifications in section 512(b)(1), (2), (3), and (5) are not available under section 512(a)(3). Nonetheless, such amounts may be excluded from UBTI if set aside (and not in excess of the set aside limit described in section 512(a)(3)(E)) for a purpose described in section 512(a)(3)(B)(i) or (ii).[6] Interest, dividends, royalties, rents, and capital gains generally are considered income from investment activities and, as stated in part 4 of this Summary of Comments and Explanation of Revisions, treated as one unrelated trade or business for purposes of section 512(a)(6). Accordingly, the proposed regulations provided 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).

Commenters generally were in favor of this approach. Accordingly, the final regulations adopt this portion of the proposed regulations without change.

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, then 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 exceed the set aside limit under section 512(a)(3)(E) and any amount that exceeds this limit is UBTI under section 512(a)(3)(A).

[5] See § 1.512(a)–5, 84 FR 67370 (Dec. 10, 2019), for a discussion of the UBTI rules as they specifically apply to VEBAs and SUBs.

[6] As explained in the introduction to part 4 of this Summary of Comments and Explanation of Revisions, 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).

As discussed in part 4.a.i of this Summary of Comments and Explanation of Revisions, the amounts that may be set aside under section 512(a)(3)(B)(i) or (ii) are income from the social club, VEBA, or SUB's investment activities. Therefore, the proposed regulations also provided 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 also includes any amount in excess of the set aside limit described in section 512(a)(3)(E).

No comments were received on this section of the proposed regulations and it is therefore adopted as final.

b. Social Club Activities

i. Limitation on Investment Activities

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.* at 4 (''It is not intended that these organizations should be permitted to receive . . . income from the active conduct of businesses not traditionally carried on by these organizations.''). Accordingly, consistent with Notice 2018–67, the proposed regulations provided 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.

One commenter recommended that social clubs should have access to the de minimis test for investments in partnerships. The commenter states that partnership holdings may include exclusively items that are described in section 512(b)(1), (2), (3), and (5) and that social clubs would have equal difficulty determining the underlying trade or business as other exempt organization investors.

The Treasury Department and the IRS do not adopt the commenter's recommendation for the following reasons. To the extent that a social club is invested in a partnership all of the holdings of which would be excluded under section 512(b)(1), (2), (3), and (5) if the social club were subject to section 512(a)(1), then all such income is part of the social club's investment activities trade or business without application of the de minimis test. To the extent that a social club holds, directly or indirectly, an interest in a partnership that is performing a non-traditional, unrelated trade or business, then under section 512(c) the social club itself is engaged in a non-traditional, unrelated trade or business. Because a social club's nontraditional activities could jeopardize a social club's exemption, it is incumbent upon the social club to know the type and amount of such activities without regard to section 512(a)(6). Thus, the Treasury Department and the IRS do not consider the administrative convenience rationale supporting the QPI rule as relevant for social clubs and do not adopt the commenter's recommendation.

ii. Nonmember Activities

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 the preamble to the proposed regulations, a social club cannot use the NAICS 2-digit code generally describing golf courses and country clubs (71) to describe all its nonmember 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 nonmember income, such as greens fees, other NAICS codes may be more appropriate to describe other nonmember 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 part 1 of this Summary of Comments and Explanation of Revisions, like an exempt organization subject to section 512(a)(1). See part 1.c of this Summary of Comments and Explanation of Revisions for a discussion of how to identify the appropriate NAICS 2-digit code.

Commenters again 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). The commenters stated 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. One commenter also stated that, because the treatment of UBTI for social clubs under section 512(a)(3) is different from that of other exempt organizations' treatment of UBTI under section 512(a)(1), using different rules to identify the separate unrelated trades or businesses for social clubs was reasonable. Finally, a commenter provided that, because social clubs are already capped at 15 percent of their revenue from nonmember activities, aggregating all nonmember income under that cap has a de minimis effect on taxable income while greatly decreasing the administrative burden of such organizations.

Section 512(a)(3) taxes all income, other than exempt function income, of the exempt organizations subject to that section, while section 512(a)(1) taxes only the income from the unrelated trades or businesses of all other exempt organizations. As a result, section 512(a)(3) captures a broader group of sources of income than under section 512(a)(1). Further, Congress has previously expressed a desire to limit the nonmember income of a social club to 15 percent of all income and to constrain further the non-traditional trades or businesses of a social club. *See* S. Rep. No. 94–1318, at 4. Social clubs would be in a more favorable tax position if social clubs were permitted to aggregate income that organizations subject to section 512(a)(1) would not be able to aggregate if they performed the same activities. The Treasury Department and the IRS are not persuaded that social clubs should have a more favorable position under section 512(a)(6) than other exempt organizations. Additionally, section 512(a)(6) does not specifically except social clubs, nor does it except a social club's nonmember income. Accordingly, the Treasury Department and the IRS do not adopt the recommendation to treat all of a social club's nonmember income as a single unrelated trade or business.

One commenter recommended that social clubs be permitted to use the Uniform System of Financial Reporting for Clubs that is produced jointly by Hospitality Financial and Technology Professionals and Club Managers Association of America. This commenter stated that this system would better represent separate unrelated trades or businesses historically identified by social clubs.

The accounting system recommended by the commenter is a proprietary system that is not available for public use. Adopting this system as the required method of identifying a separate unrelated trade or business for social clubs would require all such clubs to purchase the materials of a third-party provider. Accordingly, the Treasury Department and the IRS do not adopt the Uniform System of Financial Reporting for Clubs as a method of identifying a separate unrelated trade or business for social clubs.

The final regulations adopt the proposed regulations' treatment of a social club's nonmember activities without change.

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).''

These final 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). In the preamble to the proposed regulations, the Treasury Department and the IRS requested 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).

Multiple commenters provided several facts and circumstances that might assist a social club in identifying the separate unrelated trade or business associated with the non-recurring activity. However, the Treasury Department and the IRS have determined that, due to the limited nature of these activities and the great variety of such circumstances, the inclusion of such a list of factors within the final regulations is not warranted at this time. Accordingly, the Treasury Department and the IRS do not adopt any additional factors for social clubs to consider when identifying the separate trade or business of the non-recurring activity. Social clubs can rely on the general rules in the final regulations for identifying a separate trade or business to identify the separate trade or business associated with non-recurring events.

iv. Activities Without a Profit Motive

As discussed in part 1 of this Summary of Comments and Explanation of Revisions, § 1.513–1(b) provides 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.'' The requirement for a trade or business to have an intent to profit is further supported by case law. *See, e.g., Commissioner* v. *Groetzinger,* 480 U.S. 23, 35 (1987) (stating that, ''to be engaged in a trade or business, . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit''). This profit motive requirement was applied to the unrelated trades or businesses of a social club in *Portland Golf Club* v. *Commissioner,* 497 U.S. 154 (1990) (finding that, under section 512(a)(3) prior to the enactment of section 512(a)(6), the golf club could use nonmember sales losses for food and drink to offset investment income only if the sales were motivated by an intent to profit, and in demonstrating the requisite profit motive, the golf club had to employ the same method of allocating fixed expenses as it used in calculating its actual loss).

One commenter on the proposed regulations requested that the Treasury Department and the IRS clarify that nonmember activities conducted without intent to profit are not unrelated trades or businesses. In the preamble to the proposed regulations, the Treasury Department and the IRS declined to address this comment in the proposed regulations because it is adequately addressed by existing precedent and cited to *Portland Golf.*

In response to the preamble of the proposed regulations, one commenter stated that a specific trade or business activity must be identified prior to determining whether it creates losses on a consistent basis. Given that the trade or business activity must first be identified, and that the proposed regulations prescribed the use of NAICS 2-digit codes for identifying a separate unrelated trade or business, the commenter noted that a social club must first identify the appropriate NAICS 2-digit code for a trade or business activity and determine whether the trade or business activity represented by that NAICS 2-digit code generates losses on a consistent basis (and thus may lack the requisite profit motive to be a trade or business at all for UBIT purposes). Under this analysis, the commenter recommended allowing exempt organizations to include, or exclude, certain activities from a trade or business based on the social club's internal determination that the activity lacks a profit motive.

The Treasury Department and the IRS agree that profit motive is relevant to determining whether an activity is a trade or business and that an exempt organization has a separate unrelated trade or business for purposes of section 512(a)(6) only if the activity being analyzed as separate is a trade or business. The Treasury Department and the IRS also agree that, for UBIT purposes, the appropriate level for determining whether a profit motive exists (based on the generation of consistent losses) with regard to an activity as a trade or business is the NAICS 2-digit level since the Treasury Department and the IRS have determined that the NAICS 2-digit codes appropriately identify separate unrelated trades or businesses.

However, the Treasury Department and the IRS do not adopt the commenter's recommendation to allow exempt organizations to exclude certain activities from the UBTI calculation based on the organization's assertion of a lack of intention to make a profit. In determining the lack of a profit motive, greater weight is given to objective facts than to a taxpayer's intent. *See, e.g.,* § 1.183–2(a). Thus, an exempt organization would need to demonstrate a factual lack of profit motive rather than claiming a lack of intent without any demonstrated losses. Furthermore, in light of the purpose and effect of section 512(a)(6) to not permit losses from one trade or business to offset income from another trade or business, the commenter's recommendation would only benefit exempt organizations if the exempt organization could exclude income from a trade or business activity (first separated on the basis of the NAICS 2-digit code levels) from UBTI on an assertion that the exempt organization has no profit motive with regard to such activity notwithstanding the income from that activity. The Treasury Department and the IRS do not see any basis for providing such a rule.

5. Total UBTI and the Charitable Contribution Deduction

Consistent with section 512(a)(6), the proposed regulations provided that the total UBTI of an exempt organization with more than one unrelated trade or business is the sum of the UBTI with respect to each separate unrelated trade or business, less the specific deduction under section 512(b)(12), and that the UBTI with respect to any separate unrelated trade or business cannot be less than zero.

Section 512(b)(10) and (11) permit exempt organizations to take a charitable contribution deduction. The amount of this deduction, in the case of section 512(b)(10), which applies to most exempt organizations, is limited to 10 percent of UBTI computed without application of the charitable contribution deduction and, in the case of section 512(b)(11), which applies to certain trusts, is limited to the amounts described in section 170(b)(1)(A) and (B) determined with reference to UBTI, again, computed without application of the charitable contribution deduction. The proposed regulations clarified 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). As a result, the limitations on the charitable contribution deduction would be computed using total UBTI under section 512(a)(6)(B).

Although the proposed regulations clarified how to calculate the limitation on the charitable contribution deduction (that is, using total UBTI), the proposed regulations did not explicitly state, other than in the preamble, that the charitable contribution deduction was to be taken against total UBTI. Accordingly, the final regulations have been revised to clarify that the total UBTI of an exempt organization with more than one unrelated trade or business is the sum of the UBTI with respect to each separate unrelated trade or business, less a charitable contribution deduction, an NOL deduction for losses arising in taxable years beginning before January 1, 2018 (discussed in part 6 of this Summary of Comments and Explanation of Revisions), and a specific deduction under section 512(b)(12), as applicable.

One commenter asserted that certain expenses, such as tax return preparation fees and state taxes, are difficult to allocate between two or more unrelated trades or businesses and recommended that exempt organizations be permitted to deduct such expenses against total UBTI. Similarly, this commenter recommended that investment management fees be deducted against total investment related UBTI (instead of total UBTI). In support of this suggestion, this commenter noted that the proposed regulations permitted the charitable contribution deduction in section 512(b)(10) and (11) to be taken against total UBTI.

The final regulations do not adopt this commenter's recommendations. First, the charitable contribution deduction in section 512(b)(10) and (11) is distinguishable from other deductions under section 512(a)(1) or (3) or section 512(b) because the Code specifically provides that this deduction is permitted ''whether or not directly connected with the carrying on of an unrelated trade or business.'' Accordingly, the Treasury Department and the IRS determined that the charitable contribution deduction could be taken against total UBTI calculated under section 512(a)(6)(B).

Second, the structure of section 512(a)(6) itself confirms that Congress did not intend for any deductions to be taken against total UBTI calculated under section 512(a)(6)(B) other than the ones specifically permitted. Section 512(a)(6)(A) provides that, when calculating the UBTI of a separate unrelated trade or business, such calculation is made ''without regard to'' the specific deduction in section 512(b)(12). Section 512(a)(6)(B) clarifies that total UBTI is the sum of UBTI computed with respect to each separate unrelated trade or business ''less a specific deduction under [section] 512(b)(12).'' Thus, the only deductions permitted against total UBTI are a charitable contribution deduction under section 512(b)(10) and (11), an NOL deduction for losses arising in taxable years beginning before January 1, 2018 (permitted by section 13702(b)(2) of the TCJA), and a specific deduction under section 512(b)(12). All other deductions are taken against the UBTI of each separate unrelated trade or business, provided that each such deduction meets the requirements of section 512(a)(1) or (3), as applicable. Any deduction attributable to more than one unrelated trade or business must be allocated in accordance with § 1.512(a)–1(c) of the current regulations.

6. NOLs and UBTI

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

Consistent with the statute and the proposed regulations, the final regulations provide that, 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. Also consistent with the proposed regulations, the final regulations provide that § 1.512(b)–1(e), which addresses the application of section 172 in the context of UBIT, applies separately with respect to each such unrelated trade or business.

b. Coordination of NOLs

The proposed regulations provided that an organization with losses arising in a taxable year beginning before January 1, 2018 (pre-2018 NOLs), and losses arising in a taxable year beginning after December 31, 2017 (post-2017 NOLs), 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. One commenter recommended that an exempt organization be permitted to choose the order in which it uses pre-2018 and post-2017 NOLs based on its own facts and circumstances.

The Treasury Department and the IRS do not accept this recommendation. Section 1.172–4(a)(3) of the current regulations provides that the amount which is carried back or carried over to any taxable year is an NOL ''to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over.'' This section further provides that, for the purpose of determining the taxable (or net) income for any such preceding taxable year, the various NOL carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year. Furthermore, in Notice 2018–67, the Treasury Department and the IRS noted that section 512(a)(6) may have changed the order in which NOLs are taken and 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. Comments received in response to Notice 2018–67 noted that section 512(a)(6) does not alter the ordering rules under section 172 and 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 commenter on the proposed regulations provided no new information that would support changing the NOL ordering rule for purposes of section 512(a)(6). Accordingly, the final regulations adopt the proposed regulations without change.

The proposed regulations further provided that pre-2018 NOLs are taken against total UBTI in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year. One commenter requested that the final regulations clarify the methodology or principle that should be used to allocate pre-2018 NOLs among separate unrelated trades or businesses. The methods suggested by this commenter would result in the pro-rata distribution of pre-2018 NOLs based on various factors, such as the ratio of UBTI of a separate unrelated trade or business to total UBTI. In the alternative, two commenters proposed that an exempt organization be permitted to use any reasonable method to allocate its pre-2018 NOLs.

Although pre-2018 NOLs are taken against total UBTI, pre-2018 NOLs must be allocated in some manner between separate unrelated trades or businesses to determine the amount of pre-2018 NOLs actually taken in a taxable year because the UBTI with respect to each separate unrelated trade or business is calculated before total UBTI and post-2017 NOLs are taken against the UBTI of the separate unrelated trade or business in which they arose. Pre-2018 NOLs could be allocated any number of ways, including ratably between separate unrelated trades or businesses or only to those separate unrelated trades or businesses with no post-2017 NOLs. In permitting the ''maximum utilization of the pre-2018 NOLs in a taxable year'' in the proposed regulations, the Treasury Department and the IRS intended to provide exempt organizations with the flexibility to choose how to allocate pre-2018 NOLs among separate unrelated trades or businesses. However, the actual effect of this rule is to permit an exempt organization to maximize post-2017 NOLs taken against the UBTI from the separate unrelated trades or businesses after taking the pre-2018 NOLs. Accordingly, the final regulations clarify that pre-2018 NOLs are taken against the total UBTI in a manner that allows for maximum utilization of post-2017 NOLs, rather than pre-2018 NOLs, in a taxable year. For example, the final regulations further clarify that an exempt organization may allocate all of its pre-2018 NOLs to one of its separate unrelated trades or businesses or it may allocate its pre-2018 NOLs ratably among its separate unrelated trades or businesses, whichever results in the greater utilization of the post-2017 NOLs in that taxable year.

Additionally, several commenters requested guidance regarding how changes made to section 172 by the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136, 134 Stat. 281 (2020) (CARES Act) would affect section 512(a)(6). The Treasury Department and the IRS are considering how these changes affect the calculation of UBTI under section 512(a)(6) and expect to publish additional guidance on the issue. It is anticipated that this additional guidance will include examples that illustrate both how the changes to the CARES Act affect the calculation of UBTI as well as how an exempt organization calculates UBTI when it has pre-2018 NOLs, either with or without post-2017 NOLs.

c. Treatment of NOLs Upon Sale, Transfer, Termination, or Other Disposition of a Separate Unrelated Trade or Business

Several commenters requested guidance on the treatment of accumulated NOLs upon the sale, transfer, termination, or other disposition of a separate unrelated trade or business. At least one commenter recommended that, in such an event, the use of all such prior losses be applied first to any gain realized on the disposition of the trade or business and that any remaining losses be permitted to offset UBTI from other, separate unrelated trades or businesses. Another commenter recommended that any accumulated NOLs be suspended and taken if the exempt organization later resumes the separate unrelated trade or business.

Section 512(a)(6) permits only pre-2018 NOLs to be taken against total UBTI. Consistent with the legislative intent of section 512(a)(6), losses attributable to a separate unrelated trade or business may be taken only against income from that separate unrelated trade or business. However, the Treasury Department and the IRS recognize that an exempt organization later may recommence that separate unrelated trade or business or acquire a separate unrelated trade or business identified in the same manner. Accordingly, the final regulations provide that, after offsetting any gain from the termination, sale, exchange, or other disposition of a separate unrelated trade or business, any NOL remaining is suspended. However, the suspended NOLs may be used if that previous separate unrelated trade or business is later resumed or if a new unrelated trade or business that is accurately identified using the same NAICS 2-digit code as the previous separate unrelated trade or business is commenced or acquired in a future taxable year.

d. Treatment of NOLs Upon Changing Identification of a Separate Unrelated Trade or Business

Six commenters requested that the final regulations clarify what happens to NOLs when a partnership interest moves in and out of QPI status. The Treasury Department and the IRS expect that the grace period described in part 2.b.vi of this Summary of Comments and Explanation of Revisions will reduce the incidence of partnership interests moving in and out of QPI status. Nonetheless, instances will exist where a partnership interest that was a QPI becomes a non-QPI. Additionally, as discussed in part 1.d of this Summary of Comments and Explanation of Revisions, an exempt organization may change the NAICS 2-digit code identifying a separate unrelated trade or business. Thus, the same question exists regarding what happens to NOLs when the NAICS 2-digit code identifying a separate unrelated trade or business changes.

In response to the commenters, the final regulations generally provide that, for purposes of section 512(a)(6), a separate unrelated trade or business that changes identification is treated as if the originally identified separate unrelated trade or business is terminated and a new separate unrelated trade or business is commenced. As a result, none of the NOLs from the previously identified separate unrelated trade or business will be carried over to the newly identified separate unrelated trade or business. For example, if the nature of a separate unrelated trade or business changes such that it is more accurately described by another NAICS 2-digit code, the separate unrelated trade or business is treated as a new separate unrelated trade or business with no NOLs.

The final regulations further clarify that the change in identification may apply to all or a part of the originally identified separate unrelated trade or business. If the change in identification applies to the originally identified separate trade or business in its entirety, any NOLs attributable to that separate unrelated trade or business are suspended. If the change in identification applies to the originally identified separate unrelated trade or business in part, to aid in tax administration and to avoid a need for allocation of NOLs within an originally identified separate trade or business, the originally identified separate unrelated trade or business that is not changing retains the full NOLs attributable to it, including the portion for which the identification is changing. Additionally, the final regulations provide that this general rule also applies to the separate unrelated trades or businesses that are identified when a QPI becomes a non-QPI. In this case, any NOLs attributable to the QPI that became a non-QPI are retained with the organization's investment activities.

Under the final regulations, a change in identification is effective as of the first day of the taxable year in which the change is made. Accordingly, the final regulations treat the newly identified separate unrelated trade or business as commencing on this date.

Nonetheless, the final regulations provide an exception for when an organization has determined that an unrelated trade or business is more accurately identified by another NAICS 2-digit code, provided that there has been no material change in the unrelated trade or business. In these cases, the final regulations provide that the NOLs attributable to the previously identified separate unrelated trade or business are NOLs of the newly identified separate unrelated trade or business. This approach is consistent with the legislative intent that losses from one unrelated trade or business not be used to offset the gains from another unrelated trade or business but recognizes that mistakes may be made and that NOLs should not be suspended (as discussed in part 6.c of this Summary of Comments and Explanation of Revisions) in such a case. The final regulations provide examples illustrating the application of these rules regarding NOLs.

e. Coordination of NOL and Excess Charitable Contribution Carryovers

The proposed regulations requested comments on the coordination of NOL and excess contribution carryovers. The proposed regulations noted that an ordering rule may be necessary. Although a few comments were received, these final regulations do not address this issue. The Treasury Department and the IRS continue to consider this issue and will issue additional guidance, if needed.

7. Form 990–T

At least one commenter requested clarification regarding the reporting of separate unrelated trades or businesses that do not have corresponding NAICS codes, such as investment activities, income from certain controlled entities, and non-qualifying S corporation interests. The IRS is in the process of revising the 2020 Form 990–T and related instructions. It is anticipated that separate unrelated trades or businesses that are not identified using NAICS 2-digit codes—that is, separate unrelated trades or businesses identified under § 1.512(a)–6(c) (investment activities), (d)(1) (specified payments from controlled entities), (d)(2) (certain amounts derived from controlled foreign corporations), and (e) (non-qualifying S corporation interests)—will be identified using numeric codes distinguishable from NAICS codes. The instructions to the Form 990–T will explain how an exempt organization determines the appropriate code to use, as well as how to report code changes.

8. Waiver of Penalties Not Provided

One commenter requested that the Treasury Department and the IRS waive any penalties arising from the underpayment of tax for tax years prior to the applicability date of the final regulations. As discussed in the Applicability Dates section of this preamble, an exempt organization may rely on a reasonable, good-faith interpretation of section 512(a)(6) prior to the applicability date of the final regulations. Accordingly, the Treasury Department and the IRS decline to waive any underpayment penalties with respect to the calculation of UBTI under section 512(a)(6).

9. Individual Retirement Accounts

The proposed regulations added a new paragraph to § 1.513–1 clarifying that the section 513(b) definition of ''unrelated trade or business'' applies to individual retirement accounts (IRAs) described in section 408. No comments were received with respect to this provision. Accordingly, the final regulations adopt these proposed regulations without change.

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

The proposed regulations revised § 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 global intangible low-taxed income (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). At least one commenter explicitly supported this treatment of an inclusion of subpart F income or GILTI and no other comments were received. Therefore, the final regulations adopt these proposed regulations without change.

11. Public Support

The preamble to the proposed regulations confirmed that section 512(a)(6) potentially impacted the calculation of public support under sections 509(a)(1) and 170(b)(1)(A)(vi) and under section 509(a)(2) (the public support tests) because of the inability of an exempt organization with more than one unrelated trade or business to use losses from one unrelated trade or business to offset gains from another unrelated trade or business. Furthermore, the preamble to the proposed regulations noted that the Treasury Department and the IRS were not aware of any congressional intent to change the public support tests in enacting section 512(a)(6). Accordingly, the proposed regulations revised §§ 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 unrelated trades or businesses within the meaning of section 512, for purposes of determining whether an organization is publicly supported.

Commenters agreed that Congress likely did not intend to change the public support tests when enacting section 512(a)(6) and generally supported the proposed clarifications to the public support test. However, two commenters noted that an exempt organization that satisfies the public support tests using its UBTI calculated for purposes of section 512(a)(6) also will satisfy the public support tests if it calculates its UBTI in the aggregate. These commenters therefore recommended that an exempt organization be permitted to use either its UBTI calculated under section 512(a)(6) or its UBTI calculated in the aggregate to determine public support.

These commenters noted that this approach would reduce the administrative burden on exempt organizations because organizations that satisfy the requirements of the public support test using their UBTI calculated under section 512(a)(6) would not be required to recalculate UBTI in the aggregate. At the same time, this approach would also address any unintended consequence of the enactment of section 512(a)(6) for exempt organizations that have historically satisfied the requirements of the public support test but would no longer because of the effect of section 512(a)(6). The final regulations adopt these commenters' suggestions and permit an exempt organization with more than one unrelated trade or business to determine public support using either its UBTI calculated under section 512(a)(6) or its UBTI calculated in the aggregate.

12. Technical Correction of Inadvertently Omitted Regulatory Language

The proposed regulations made a technical correction to § 1.512(a)–1(b) by including language that was omitted from the **Federal Register** when the final regulation was published in 1975. No comments were received with respect to this technical correction. Accordingly, the final regulations adopt the technical correction in the proposed regulations without change.

Applicability Dates

The proposed regulations were proposed to apply to taxable years beginning on or after the date the regulations were published in the **Federal Register** as final regulations. Two commenters recommended that the applicability date of the final regulations be delayed. Another commenter suggested that the applicability date be extended such that all exempt organizations be provided with at least one year before the final regulations are applicable. This commenter explained that time will be required to implement the final regulations, including making changes to accounting systems. Accordingly, this commenter proposed that the applicability date of the final regulations be extended to the first day of the second taxable year beginning after the date the final regulations are published in the **Federal Register**.

The Treasury Department and the IRS recognize that implementation of the requirements of section 512(a)(6) by some exempt organizations requires changes to the way these organizations track income and expenses. However, the Treasury Department and the IRS have provided guidance regarding how exempt organizations would be expected to comply with section 512(a)(6) starting with Notice 2018–67 in September of 2018 and continuing with the proposed regulations in April of 2020. The final regulations adopt the proposed regulations with minor changes requested by commenters. Accordingly, consistent with the proposed regulations, the final regulations are applicable to taxable years beginning on or after December 2, 2020. In addition, an exempt organization may choose to apply the final regulations under section 512(a)(6), as well as the final regulations relating to the calculation of public support, to taxable years beginning on or after January 1, 2018, and before December 2, 2020. Alternatively, an exempt organization may rely on a reasonable, good-faith interpretation of section 512(a)(6) for such taxable years. For this purpose, a reasonable good faith interpretation includes the methods of aggregating or identifying separate trades or businesses provided in Notice 2018–67 or the proposed regulations.

With respect to the inclusions of subpart F income or GILTI discussed in part 10 of the Summary of Comments and Explanation of Revisions, a taxpayer may choose to apply the final regulations under § 1.512(b)–1(a) to taxable years beginning before December 2, 2020 consistent with the longstanding position of the Treasury Department and the IRS on the inclusion of subpart F income under section 951(a)(1)(A).

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.

These final regulations have been designated as significant and subject to review under Executive Order 12866 and section 1(b) of the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. For purposes of Executive Order 13771, the final regulations are regulatory. The Administrator of the Office of Information and Regulatory Affairs (OIRA), Office of Management and Budget, has waived review of this rule in accordance with section 6(a)(3)(A) of Executive Order 12866.

1. 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 unrelated trade or business activity could be used to offset profits from another unrelated trade or business 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.

On April 21, 2020, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG–106864–18) in the **Federal Register** (85 FR 23172) containing proposed regulations under section 512 (proposed regulations). The final regulations retain the basic approach and structure of the proposed regulations with certain minor modifications. As part of these modifications, the final regulations modify the participation test (called the ''control test'' in the proposed regulations) to permit indirectly held partnerships interests to be eligible for inclusion in an exempt organization's single ''investment activities'' trade or business. The final 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 final 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.

2. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of these proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

3. Affected Entities

Prior tax law did not require tax-exempt organizations to report unrelated business income by separate activity, so it is not possible to obtain accurate counts of the number of exempt organizations potentially affected by the final regulations. However, the IRS estimates that less than 2 percent of exempt organizations would be affected, as calculated below.

Approximately 1.4 million exempt organizations filed some type of information or tax return with the IRS for fiscal year 2018.[7] 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 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.[8] 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 or approximately 4,000 filers would be affected by the final regulations and that these would tend to be large educational or arts and cultural organizations.

4. Economic Analysis of Final Regulations

The final regulations provide greater certainty to exempt organizations regarding how to compute UBTI and tax in response to the changes made by TCJA. 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 major provisions of the final rule and provides a qualitative economic analysis of each one.

a. Identifying Separate Trades or Businesses

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 used to offset only income from the same unrelated trade or business. The final regulations generally require the use of NAICS codes to identify 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. The final regulations allow the use of NAICS 2-digit codes, which encompass broader categories of trades or businesses than NAICS 6-digit codes, to reduce the compliance burdens for exempt organizations with multiple similar types of business activity. For example, different types of food services would be included 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 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. In addition, exempt organizations may need to incur the costs of changing their accounting systems so as to collect the information needed for separate NAICS 6-digit codes.

Some commenters to the proposed regulations advocated using the NAICS 2-digit codes as a safe-harbor when identifying separate unrelated trades or businesses and that a facts and circumstances test be applied as the primary method of identifying separate unrelated businesses. Adoption of a facts and circumstances test would increase the administrative burden of tax-exempt organizations in complying with section 512(a)(6) because fact-intensive analysis would be required to determine each unrelated trade or business. Additionally, adoption of a facts and circumstances test would offer exempt organizations less certainty and increase the IRS administrative burden.

The guidance provided in the final regulations 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 interpretations of the statute. In the absence of these final regulations, an exempt organization might be uncertain about whether an activity is one or more than one trade or business. As a result, in the absence of the final regulations, similar institutions might take different positions and pay different amounts of tax, introducing economic inefficiency and inequity. These regulations provide

[7] *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).

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

greater certainty and flexibility such that compliance costs may be slightly lower for affected organizations relative to a no-action baseline.

b. Aggregation of Investment Activities

The final regulation's treatment of investment activities will also provide clarity and reduce burdens for exempt organizations. By providing explicit rules for the treatment of investment activities, the final regulations reduce the uncertainty about what would be acceptable under a reasonable, good-faith interpretation. Although investment income, such as interest and dividend income, is not generally statutorily 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. The final regulations allow certain of this investment income to be aggregated and treated as a single trade or business. The final regulations provide rules for the treatment of partnership income and explicitly list the other types of UBTI that can be aggregated as ''investment'' income in response to comments requesting additional clarification. The allowance of this type of aggregation is responsive to situations where exempt organizations are invested in partnerships in which they do not significantly participate. The allowance of aggregation in the final regulations recognizes that in these situations the exempt organizations are unlikely to be able to access information from such partnerships for purposes of separating the partnerships' investments according to NAICS codes. As a result, the final 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.

c. Summary

The final 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 final 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 final 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 final regulations will be modest relative to the no-action baseline.

II. Paperwork Reduction Act

The collections of information contained in the final regulations will be submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of (1995) (44 U.S.C. 3507(d)). 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 law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

1. Collections of Information Imposed by the Regulations

The collection of information in these final 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.

2. Burden Estimates

The burden associated with Form 990–T is included in the aggregated burden estimates for OMB control number 1545–0047. The burden estimates in 1545–0047 relate to all filers associated with the Forms 990, and will in the future include, but not isolate, the estimated burden of the information collections associated with these final regulations.

No burden estimates specific to the final 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 final regulations. Those estimates would capture both changes made by the Act and those that arise out of discretionary authority exercised in the final regulations. The current status of the Paperwork Reduction Act submissions related to these final 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.*	

In the proposed regulations, the Treasury Department and the IRS requested comments on all aspects of information collection burdens related to the 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. The Treasury Department and the IRS did not receive any comments on these issues. Proposed revisions (if any) to the forms that reflect the information collections contained in these final regulations will be made available for public comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.html* and 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-pubs/comment-on-tax-forms-and-publications*.

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. In the proposed regulations, the Treasury Department and the IRS invited comments on the impact this rule may have on small entities. The Treasury Department and the IRS did not receive any comments on this issue. As discussed elsewhere in this section, these final 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 final 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). Accordingly, approximately 10 percent of the exempt organization population file Form 990–T. This population includes large hospital systems and universities not included in the SBA definition of ''small entities.'' Therefore, these final regulations are 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 these final rules are 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 separate unrelated trades or businesses for the previous two tax years. As discussed elsewhere in this section, these regulations 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 these final regulations, the Treasury Department and the IRS project that the final regulations provide certainty and guidance that will reduce taxpayer compliance burden for large and small entity taxpayers. Accordingly, the Secretary of the Treasury's delegate certifies that these regulations will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business (84 FR 31795). No comments on the notice were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

IV. Congressional Review Act

The Office of Management and Budget has determined that the final rule is not a ''major rule'' within the meaning of the Congressional Review Act (5 U.S.C. 801, *et seq.*).

V. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The final regulations do not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

VII. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The final regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Drafting Information

The principal authors of these regulations are Stephanie N. Robbins and Jonathan A. Carter, 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.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 are 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 amended by:

■ 1. Adding paragraph (f)(7)(v).

■ 2. Adding 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 this paragraph (f)(7)), 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. Nonetheless, when determining support, such organization can use either its UBTI calculated under section 512(a)(6) or its UBTI calculated in the aggregate.

* * * * *

(k) * * *

(3) *Applicability date.* Paragraph (f)(7)(v) of this section applies to taxable years beginning on or after December 2, 2020. Taxpayers may choose to apply this section to taxable years beginning on or after January 1, 2018, and before December 2, 2020.

■ **Par. 3.** Section 1.509(a)–3 is 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), or with regard to section 512(a)(6), if the organization so chooses) 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. Nonetheless, when determining support, such organization can use either its UBTI calculated under section 512(a)(6) or its UBTI calculated in the aggregate.

* * * * *

(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 December 2, 2020. Taxpayers may choose to apply this section to taxable years beginning on or after January 1, 2018, and before December 2, 2020. Otherwise, for taxable years beginning before December 2, 2020, see these paragraphs as in effect and contained in 26 CFR part 1 revised as of April 1, 2020.

■ **Par. 4.** Section 1.512(a)–1 is 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 is not reasonable if the cost of providing a good or service in a related and an unrelated activity is substantially the same, but the price charged for that good or service in the unrelated activity is greater than the price charged in the related activity and no adjustment is made to equalize the price difference for purposes of allocating expenses, depreciation, and similar items based on revenue between related and unrelated activities. For example, if a social club described in section 501(c)(7) charges nonmembers a higher price than it charges members for the same good or service but does not adjust the price of the good or service provided to members for purposes of allocating expenses, depreciation, and similar items attributable to the provision of that good or service, the allocation method is not reasonable.

* * * * *

(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 after December 2, 2020. For taxable years beginning before December 2, 2020, see these paragraphs as in effect and contained in 26 CFR part 1 revised as of April 1, 2020.

■ **Par. 5.** Section 1.512(a)–6 is 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) separately with respect to each such trade or business, without regard to the specific deduction in section 512(b)(12), including for purposes of determining any net operating loss (NOL) deduction. 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.* An organization determines whether it regularly carries on unrelated trades or businesses by applying sections 511 through 514. 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.

(3) *Reporting changes in identification.* An organization that changes the identification of a separate unrelated trade or business under paragraph (a)(2) of this section must report the change in the taxable year of that change in accordance with forms and instructions. For this purpose, a change in identification of a separate unrelated trade or business includes the changed identification of the separate unrelated trade or business with respect to a partnership interest that was incorrectly designated as a qualifying partnership interest (QPI). In the case of an incorrect designation of a QPI, paragraph (c)(2)(iii) of this section (regarding designation of qualifying partnership interests) does not apply. In all cases, to report the change in identification, an organization must provide the following information with respect to each separate change in identification—

(i) The identification of the separate unrelated trade or business in the previous taxable year

(ii) The identification of the separate unrelated trade or business in the current taxable year; and

(iii) The reason for the change.

(b) *North American Industry Classification System*—(1) *In general.* Except as provided in paragraphs (c) through (e) of this section, an organization identifies 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 unrelated trade or business based on the more specific NAICS code, such as at the 6-digit level, that describes the activity it conducts and subject to the requirements of paragraph (b)(2) and (3) of this section. The descriptions in the current NAICS manual (available at *www.census.gov*) of trades or businesses using more than two digits of the NAICS codes are relevant in this determination. In the case of the sale of goods, both online and in stores, the separate unrelated trade or business is identified by the goods sold in stores if the same goods generally are sold both online and in stores.

(2) *Codes must identify the unrelated trade or business.* The NAICS 2-digit code must identify the unrelated trade or business in which the organization engages (directly or indirectly) and not 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.

(3) *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.

(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) and paragraph (a) of this section. Except as provided in paragraphs (c)(7) 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 the 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 participation test (described in paragraph (c)(4) of this section).

(ii) *Indirectly-held partnership interests*—(A) *Look through rule.* If an organization holds a direct interest in a partnership but that directly-held partnership interest is not a QPI because it does not meet the requirements of the de minimis test (described in paragraph (c)(3) of this section) or the participation test (described in paragraph (c)(4) of this section), 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 paragraph (c)(2)(ii)(B) or (c)(2)(ii)(C) of this section.

(B) *Indirectly-held partnership interests that meet the requirements of the de minimis test.* An indirectly-held partnership interest meets the requirements of this paragraph (c)(2)(ii)(B) if the indirectly-held partnership interest meets the requirements of the de minimis test described in paragraph (c)(3) of this section with regard to the organization. For example, if an organization directly holds 50 percent of the capital interests of a partnership and the directly-held partnership holds 4 percent of the capital and profits interest of lower-tier partnership A, 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 × 50 percent).

(C) *Indirectly-held partnership interests that meet the requirements of the participation test.* An indirectly-held partnership interest meets the requirements of this paragraph (c)(2)(ii)(C) if the indirectly-held partnership interest meets the requirements of the participation test (described in paragraph (c)(4) of this section) with respect to the partnership that directly owns the interest in the indirectly-held partnership. For purposes of applying the participation test to a partnership, the term *organization* in paragraph (c)(4) of this section refers to the partnership that directly holds the indirectly-held partnership interest being tested for QPI status. Additionally, the list of officers, directors, trustees, or employees of an organization found in paragraphs (c)(4)(iii)(B) and (C) includes a general partner that directly owns an interest in the lower-tier partnership.

(D) *Example*—(*1*) Organization D is described in section 501(c) and is exempt from Federal income tax under section 501(a). Organization D owns 50 percent of the capital interest in Partnership A. Partnership A owns 30 percent of the capital interest in Partnership B, but Partnership A does not significantly participate in Partnership B within the meaning of paragraph (c)(4)(iii) of this section.

Further, Partnership B owns 15 percent of the capital interest in Partnership C, in which Partnership B does not significantly participate within the meaning of paragraph (c)(4)(iii) of this section. No other organizations related (within the meaning of paragraph (c)(4)(ii) of this section) to either Organization D or the partnerships owns an interest in any of the lower-tier partnerships.

(*2*) Neither the interest in Partnership A nor B is a QPI. Organization D's interest in Partnership A does not meet the requirements of either the de minimis test or the participation test because it owns 50 percent of the interest in the partnership. Organization D's indirect interest in Partnership B (50 percent of 30 percent, or 15 percent) does not meet the de minimis test. Additionally, because Partnership A owns greater than 20 percent interest in Partnership B, Partnership A's interest in Partnership B does not meet the participation test. However, Organization D's interest in Partnership C is a QPI because Partnership C meets the participation test. That is, Partnership B holds a 15 percent interest in Partnership C and does not significantly participate in Partnership C.

(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 participation test (after application of the grace period described in paragraph (c)(6) of this section, if appropriate).

(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 during the organization's taxable year with which or in which the partnership's taxable year ends.

(4) *Participation test*—(i) *In general.* A partnership interest is a QPI that meets the requirements of the participation 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 20 percent of the capital interest during the organization's taxable year with which or in which the partnership's taxable year ends and the organization does not significantly participate in 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), other than a Type III supporting organization (as defined in § 1.509(a)–4(i)) that is not a parent of its supported organization, or of a controlled entity (as defined in section 512(b)(13)(D) and § 1.512(b)–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 Type I supporting organization owns an additional 15 percent capital interest in that partnership, the organization would not meet the requirements of the participation test because its aggregate percentage interest exceeds 20 percent (10 percent + 15 percent = 25 percent).

(iii) *Significant Participation.* An organization significantly participates in a partnership if—

(A) The organization, by itself, may require the partnership to perform, or may prevent the partnership from performing (other than through a unanimous voting requirement or through minority consent rights), 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) *Determining percentage interest*—(i) *Profits interest.* For purposes of the de minimis test described in paragraph (c)(3) of this section, an organization's profits interest in a partnership is determined in the same manner as its distributive share of partnership taxable income. See section 704(b) (relating to the determination of the distributive share by the income or loss ratio) and §§ 1.704–1 through 1.704–4.

(ii) *Capital interest.* For purposes of the de minimis test (described in paragraph (c)(3) of this section) and the participation test (described in paragraph (c)(4)(i) of this section), in the absence of a provision in the partnership agreement, an organization's capital interest in a partnership is determined on the basis of its interest in the assets of the partnership which would be distributable to such organization upon its withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(iii) *Average percentage interest.* For purposes of the de minimis test (described in paragraph (c)(3) of this section) and the participation test (described in paragraph (c)(4)(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).

(iv) *Reliance on Schedule K–1 (Form 1065).* When determining the organization's average percentage interest (described in paragraph (c)(5)(iii) of this section) in a partnership for purposes of the de minimis test (described in paragraph (c)(3) of this section) and the participation 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.

(6) *Changes in percentage interest.* A partnership interest that fails to meet the requirements of the de minimis test (described in paragraph (c)(3) of this section) or the participation test (described in paragraph (c)(4) of this section) because of an increase in percentage interest in the organization's current taxable year may be treated for the taxable year of the change as meeting the requirements of the test it met in the prior taxable year if—

(i) The partnership interest met the requirements of the de minimis test or participation test, respectively, in the organization's prior taxable year without application of this paragraph (c)(6);

(ii) The increase in percentage interest is solely due to the actions of one or more partners other than the organization; and

(iii) In the case of a partnership interest that met the requirements of the participation test in the prior taxable year, the interest of the partner or partners that caused the increase in paragraph (c)(6)(ii) of this section was not combined for the prior taxable year and is not combined for the taxable year of the change with the organization's partnership interest for purposes of paragraph (c)(4)(ii) of this section.

(7) *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).

(8) *Limitations*—(i) *Social clubs.* Paragraphs (c)(2) (regarding QPIs) and (c)(9) (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, or an organization whose interest is combined with that organization's interest for purposes of paragraph (c)(4)(ii) of this section, is a general partner under applicable state law is not a QPI within the meaning of paragraph (c)(2) of this section, regardless of the organization's percentage interest. Such partnership interest cannot be a QPI for any organization or for any of the organizations whose interest is combined with that organization's interest for purposes of paragraph (c)(4)(ii) of this section.

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

(9) *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)(9)(iii) of this section).

(ii) *Exclusivity.* An organization may apply either the transition rule in paragraph (c)(9)(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)(9)(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 December 2, 2020.

(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 are 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 has two separate unrelated trades or businesses, one for each controlled entity. The specified payments from a controlled entity are 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) are 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 is 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 reports 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 for a 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 in the S corporation meets the criteria for a QPI as described in paragraph (c)(2)(i) of this section (substituting ''S corporation'' for ''partnership'' and ''shareholder'' or ''shareholders'' for ''partner'' or ''partners,'' as applicable, throughout paragraphs (c)(2)(i), (c)(3), (c)(4), (c)(5)(iii), (c)(5)(iv), and (c)(6) of this

section; ''no more than 2 percent of stock ownership'' for ''no more than 2 percent of the profits interest and no more than 2 percent of the capital interest'' in paragraph (c)(3) of this section; ''no more than 20 percent of stock ownership'' in place of ''no more than 20 percent of the capital interest'' in paragraph (c)(4)(i) of this section; and ''Schedule K–1 (Form 1120–S)'' for ''Schedule K–1 (Form 1065)'' for purposes of paragraph (c)(5)(iv) of this section). Paragraphs (c)(5)(i) and (c)(5)(ii) do not apply for purposes of determining an organization's ownership interest in an S corporation; rather, the average percentage stock ownership determined under paragraph (c)(5)(iii) of this section applies for purposes of this paragraph (e)(2). For purposes of paragraph (c)(5)(iv) of this section, an organization can rely on the Schedule K–1 (Form 1120–S) (or its successor) it receives from the S corporation only if the form lists information sufficient to determine the organization's percentage of stock ownership for the year. A Schedule K–1 (Form 1120–S) that reports ''zero'' as the organization's number of shares of stock in either the beginning or end of the S corporation's taxable year does not list information sufficient to determine the organization's percentage of stock ownership for the year. The grace period described in paragraph (c)(6) of this section applies to changes in an exempt organization's percentage of stock ownership in an S corporation.

(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 charitable contribution deduction, an NOL deduction for losses arising in taxable years beginning before January 1, 2018 (pre-2018 NOLs), and a specific deduction under section 512(b)(12), as applicable.

(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 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 a manner that allows for maximum utilization of post-2017 NOLs in a taxable year. For example, an organization could choose to allocate all of its pre-2018 NOLs to one of its separate unrelated trade or business or it could allocate its pre-2018 NOLs ratably among its separate unrelated trades or businesses, whichever results in the greatest utilization of the post-2017 NOLs in that taxable year.

(3) *Treatment of NOLs upon the termination, sale, exchange, or other disposition of a separate unrelated trade or business.* After offsetting any gain resulting from the termination, sale, exchange, or disposition of a separate unrelated trade or business, any NOL remaining is suspended. However, the suspended NOLs may be used if that previous separate unrelated trade or business is later resumed or if a new unrelated trade or business that is accurately identified using the same NAICS 2-digit code as the previous separate unrelated trade or business is commenced or acquired in a future taxable year.

(4) *Treatment of NOLs when the identification of a separate unrelated trade or business changes*—(i) *In general.* For purposes of section 512(a)(6) and this section, a separate unrelated trade or business for which the appropriate identification (within the meaning of paragraph (a) of this section) changes is treated as if the originally identified separate unrelated trade or business is terminated and a new separate unrelated trade or business is commenced. None of the NOLs from the previously identified separate unrelated trade or business will be carried over to the newly identified separate unrelated trade or business. For example, if the nature of a separate unrelated trade or business changes such that it is more accurately described by another NAICS 2-digit code, the separate unrelated trade or business is treated as a new separate unrelated trade or business with no NOLs. The change in identification may apply to all or a part of the originally identified separate unrelated trade or business. If the change in identification applies to the originally identified separate trade or business in its entirety, any NOLs attributable to that separate unrelated trade or business are suspended in accordance with paragraph (h)(3) of this section. If the change in identification applies to the originally identified separate unrelated trade or business in part, the originally identified separate unrelated trade or business that is not changing retains the full NOLs attributable to the originally identified separate unrelated trade or business, without allocation to the portion that became a newly identified separate unrelated trade or business. This paragraph (h)(4) also applies to each QPI that becomes a non-QPI. In this case, any NOLs attributable to the QPI that became a non-QPI are retained with the organization's investment activities described in paragraph (c) of this section.

(ii) *Exception for non-material changes.* In the case of a separate unrelated trade or business that is accidentally identified using the wrong NAICS 2-digit code or if an organization has determined that a separate unrelated trade or business that has not materially changed is more accurately identified by another NAICS 2-digit code, any NOL attributable to the originally identified separate unrelated trade or business becomes an NOL of the newly identified separate unrelated trade or business.

(iii) *Effective date of change in identification.* A change in identification described in this paragraph (h)(4) is effective on the first day of the taxable year in which the change in identification is made. Accordingly, the newly identified separate unrelated trade or business is treated as commencing on this date.

(iv) *Examples*—(A) *In general.* The following examples illustrate the rules described in this paragraph (h)(4).

(B) *Example 1. Erroneous code*—(*1*) Organization G is described in section 501(c) and is exempt from Federal income tax under section 501(a). In addition to its investment activities, Organization G has two separate unrelated trades or businesses—Q and R—that are identified with different NAICS 2-digit codes. Both Q and R have NOLs carried over from post-2017 taxable years.

(*2*) In Year 2 (a post-2017 taxable year), Organization G realizes that it accidentally used the wrong NAICS 2-digit code to identify R. The NOLs attributable to R under the old NAICS 2-digit code become the NOLs of R under the new NAICS 2-digit code as of the first day of Year 2.

(C) *Example 2. Material change*—(*1*) Same facts as *Example 1,* except assume that, in addition to its investment activities, Organization G has three separate unrelated trades or businesses—Q, R, and S—that are identified with different NAICS 2-digit codes. Q, R, and S all have NOLs carried over from post-2017 taxable years.

(*2*) Organization G changes the NAICS 2-digit code identifying R to the same NAICS 2-digit code identifying S because the nature of the unrelated trade or business materially changed. Any post-2017 NOLs attributable to R are suspended (see paragraph (h)(4)(i) of this section). Organization G now has two separate unrelated trades or businesses—Q and S—as of the first day of Year 2.

(D) *Example 3. Partial material change.* Same facts as *Example 1,* except assume that Organization G determines that a part of R has materially changed such that R should be identified as two separate unrelated trades or businesses—R1 and R2. R1 retains the NAICS 2-digit code originally identifying R, and R2 is identified with a new NAICS 2-digit code that is not the same NAICS 2-digit code identifying Q. R2 is treated as a new separate unrelated trade or business with no NOLs as of the first day of Year 2. Any post-2017 NOLs attributable to R remain with R1.

(E) *Example 4. QPI to non-QPI*—(*1*) Same facts as *Example 1,* but assume that Organization G has a partnership interest in T that was, for prior taxable years, a QPI included with Organization G's investment activities. In Year 3 (a post-2017 taxable year), Organization G acquires more than 20 percent of the capital interests in T. The grace period described in paragraph (c)(6) of this section does not apply because the increase in percentage interest was not due to the actions of other partners.

(*2*) T conducts two trade or business activities that are unrelated trade or business activities with respect to Organization G—T1 and T2. Both T1 and T2 will be treated as new separate unrelated trades or business as of the first day of Year 2. Organization G identifies T1 with the same NAICS 2-digit code used to identify Q and T2 with a NAICS 2-digit code that is different than the NAICS 2-digit codes used to identify Q and R. In addition to its investment activities, Organization G has three separate unrelated trades or businesses—Q, R, and T2. Any post-2017 NOLs attributable to the QPI remain with Organization G's other investment activities separate unrelated trade or business.

(i) *Applicability dates.* This section is applicable to taxable years beginning on or after December 2, 2020. Taxpayers may choose to apply this section to taxable years beginning on or after January 1, 2018, and before December 2, 2020.

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

■ 1. Revising paragraph (a)(1).

■ 2. Adding a sentence to the end of paragraph (a)(3).

■ 3. Adding paragraph (e)(5).

■ 4. Adding 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 December 2, 2020. However, an organization may choose to apply this exclusion to taxable years beginning before December 2, 2020.

* * * * *

(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 December 2, 2020. Taxpayers may choose to apply this section to taxable years beginning on or after January 1, 2018, and before December 2, 2020.

* * * * *

■ **Par. 7.** Section 1.513–1 is 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 sentence to the end of newly redesignated 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 December 2, 2020.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: November 13, 2020.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2020–25954 Filed 11–30–20; 4:15 pm]

BILLING CODE 4830–01–P