COMMITTED TO EXCELLENT CLIENT SERVICE
HANCOCK ESTABROOK, LLP
COUNSELORS AT LAW

September 2018
www.hancocklaw.com

NONPROFIT GOVERNANCE and TAX-EXEMPT ORGANIZATIONS LAW ALERT

IRS Issues Interim Guidance for Unrelated Business Taxable Income Under § 512(A)(6) for Tax-Exempt Organizations

On August 21, 2018, the Internal Revenue Service (IRS) issued much anticipated interim guidance via Notice 2018-67 to address new Section 512(a)(6) of the Internal Revenue Code established through enactment of the Tax Cuts and Jobs Act of 2017 (the "Act"). The new rule most significantly impacts tax-exempt organizations with multiple lines of business, at least one of which is considered "unrelated" to the tax-exempt purpose.

Entities organized under 501(c) are generally exempt from federal income taxation. However, such tax-exempt organizations are subject to taxation for Unrelated Business Taxable Income (UBTI), which is the gross income derived by an exempt organization from an unrelated trade or business regularly carried on by it, less any allowable deductions that are directly connected with the carrying on of such trade of business. An "unrelated trade or business" is generally considered any trade or business that is not substantially related to the exercise or performance by the exempt organization of its charitable, educational, or other purpose or function constituting its basis for tax exemption.

Prior to passage of the Act, the net income and, consequently, Net Operating Losses (NOL), of all unrelated business lines or trades of the tax-exempt organization were calculated as the aggregate net income or loss across all unrelated business lines. The new Section 512(a)(6) requires UBTI and NOL to be tracked separately for each separate line of business or trade in which the tax-exempt organization operates, and no separately identified business line may have a NOL less than zero.

Since Congress did not provide criteria for determining whether an exempt organization has more than one unrelated trade or business, or identifying separate unrelated trades or businesses for purposes of calculating UBTI, the IRS and Treasury intend to issue interim guidance and seek comments from tax-exempt organizations subject to the law in drafting the final regulations.

The IRS's interim guidance provides that until the final rules are passed, tax-exempt organizations may rely on a reasonable, good-faith standard for identifying separate trades or businesses for purposes of complying with Section 512(a)(6).

An exempt organization may consider all relevant facts and circumstances when determining whether it has more than one unrelated trade or business for purposes of Section 512(a)(6). The IRS specifically identified two methods of identifying separate lines of business that it presently considers good faith, reasonable interpretations. They are the fragmentation principle and the North American Industry Classification System (NAICS) system.

The fragmentation principle, as outlined in Sections 513(c) and 1.513-1(b) of the Internal Revenue Code, provides that an activity does not lose its identity as a trade or business merely because it is 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 an organization. The IRS Notice provides as an example a hospital pharmacy that, in conjunction with providing pharmaceutical supplies to patients in furtherance of its exempt purposes, also provides for the sale of supplies as a convenience function to its employees, patients and their families. The IRS's application of the fragmentation principle implies that if a business line or trade carried on by an exempt organization does not comply with the fragmentation principle, then by consequence it is an unrelated business or trade.

The 6-digit codes utilized in the NAICS system to classify separate industries in which an organization operates may offer more promise as a long-term solution. The NAICS is an industry classification system utilized by various federal government agencies to collect, analyze and publish statistical data related to the United States business economy. The IRS believes that the NAICS system is particularly adaptable because organizations that file the Form 990-T, "Exempt Organization Business Income Tax Return," are already required to use the 6-digit NAICS system when describing the organization's unrelated trades or business. The stated goal of the IRS is not to increase the burden on either tax-exempt organizations or the government in administering the UBTI requirements under Section 512(a)(6), and the language in the Notice indicates that the IRS currently views the NAICS system as a workable solution.

In light of the effect this change may make for exempt organizations in qualifying partnerships, the Notice allows exempt organizations to treat all qualifying partnership interests as a single trade or business. Questions related to these special rules can be directed to the authors below.

Ultimately, the IRS and Treasury are seeking a clear, administrable method to determine delineations in business lines that do not increase the administrative burden on the tax-exempt organization or the government. The IRS notice is relatively broad in its initial guidance, mandating that tax-exempt organizations follow reasonable, good faith efforts to comply with the new rules for UBTI. With an ongoing comment period that could extend into 2019, the true impact of Section 512(a)(6) is still some time away and will not be fully ascertainable by tax-exempt organizations until the IRS issues its final regulations.

If you have any questions or would like more information on the issues discussed in this communication, please contact any of the following Hancock Estabrook attorneys:

Marion Hancock Fish	315.565.4521	mfish@hancocklaw.com
Carrie J. Pollak	607.391.2860	cpollak@hancocklaw.com
Richard E. Scrimale	315.565.4502	rscrimale@hancocklaw.com
Doreen A. Simmons	315.565.4552	dsimmons@hancocklaw.com
Robert C. Whitaker, Jr.	315.565.4557	rwhitaker@hancocklaw.com
Warren D. Wolfson	315.425.7960	wwolfson@hancocklaw.com
Briana K. Wright	315.565.4525	bwright@hancocklaw.com

www.hancocklaw.com