

## IDENTIFYING SEPARATE UNRELATED TRADES OR BUSINESSES

Similar to the proposed regulations, most unrelated business activities must be classified using the first two digits of the North American Industry Classification System (NAICS) code that most accurately describes the trade or business. The IRS considered one commenter's view that the 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. In rejecting that suggested change the IRS noted that adopting 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. It further stated that a facts and circumstances test would increase the administrative burden on the IRS which, upon examination, must perform the same fact-intensive analysis on each of the unrelated trades or businesses identified by the exempt organization.

In clarifying how an exempt organization should choose an NAICS 2-digit code, the IRS reiterated that the choice of the code must focus on the separate unrelated trade or business activity engaged in, and not the NAICS 2-digit code that describes the activities the conduct of which are substantially related to the exercise or performance of the organization's exempt purpose or function. For example, a college or university exempt under Section 501(c)(3) cannot use the NAICS 2-digit code for educational services to identify all of its separate unrelated trades or businesses.

One area that the final regulations differed from the proposed regulations concerns the ability to change an NAICS 2-digit code once it has been selected and reported on Form 990-T. 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. In response to numerous comments on this issue, the final regulations remove the restriction requirements for changing NAICS 2-digit code(s). 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. To report the change, the final regulations require an organization to provide certain information with respect to each separate unrelated trade or business the identification of which changes: (1) the identification of the separate unrelated trade or business in the previous taxable year, (2) the identification of the separate unrelated trade or business in the current taxable year, and (3) the reason for the change. The IRS anticipates that the instructions to the Form 990-T will be revised to provide instructions regarding where and how changes in identification are reported.