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Report No. 1439
June 23, 2020

The Honorable David J. Kautter
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The Honorable Charles P. Rettig
Commissioner
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The Honorable Michael J. Desmond
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Internal Revenue Service
1111 Constitution Avenue, NW
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Re: *Report No. 1439 – Report on Proposed Section 512(a)(6) Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1439 commenting on the proposed regulations under Section 512(a)(6) of the Code issued in April of this year

We commend the Internal Revenue Service and the Department of the Treasury for the thoughtful guidance in the proposed regulations. We generally endorse the approach of the proposed regulations in providing administratively practical guidance for tax-exempt organizations and the government. Our comments are primarily directed at providing consistent reaults for economically equivalent investments.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to

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Respectfully submitted,

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Report No. 1439

New York State Bar Association Tax Section

REPORT ON PROPOSED SECTION 512(A)(6) REGULATIONS

June 23, 2020

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I. Introduction

This report (the "***Report***")[1] provides comments on proposed regulations (the "***Proposed Regulations***")[2] issued by the Department of the Treasury ("***Treasury***") and Internal Revenue Service (the "***IRS***") on April 24, 2020 to implement section 512(a)(6) of the Internal Revenue Code (the "***Code***").[3] Section 512(a)(6) was enacted as part of the so-called Tax Cuts and Jobs Act of 2017 (the "***TCJA***") to limit the ability of exempt organizations subject to the unrelated business income tax under section 511 to use losses from one unrelated business to shelter or reduce the tax on income from another unrelated business.

Specifically, section 512(a)(6)(A) provides that unrelated business taxable income ("***UBTI***") will be computed separately for each unrelated trade or business and that the amount subject to tax will be the sum of the separately computed amounts (but not below zero) for each unrelated trade or business conducted by the exempt organization. The legislative history makes clear that a net operating loss ("***NOL***") of a separate unrelated trade or business incurred after 2017 may be carried back or forward under the rules of section 172 but taken into account only in computing the unrelated business income of the separate trade or business that generated the loss.

In August 2018, Treasury and the IRS issued Notice 2018-67 (the "***Notice***") to provide interim guidance on the application of section 512(a)(6) and to request comments on the significant issues raised by the statute, including, without limitation, how to determine separate businesses and the treatment of investment activities through interests in partnerships the income from which was subject to tax. The interim guidance in the Notice (1) suggested that the NAICS six-digit codes would be treated as a reasonable, good-faith interpretation of sections 511 through 514 for identifying separate trades or businesses for purposes of section 512(a)(6); (2) allowed partnership interests that met either a de minimis test (including through a look-through rule) or a control test to be treated as "qualified partnership interests" ("***QPIs***"), which could be aggregated as a single trade or business, and (3) provided a transition rule for partnership interests acquired prior to August 21, 2018 that would allow exempt organizations to treat each such partnership interest as comprising a single trade or business, regardless of whether the partnership conducted more than one trade or business (either directly or indirectly through lower-tier partnership interests). With modifications and liberalizations, the Proposed Regulations largely adopt these proposals.

Part II of this Report summarizes our recommendations and requests for guidance. Part III provides background and a general summary of the Proposed Regulations and the relevant

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[1] The principal drafters of this Report were Stuart Rosow, Janicelynn Asamoto Park, and Bowon Koh, with substantial assistance from Andrew Meiser, Amanda Nussbaum, and Richard Upton. Helpful comments were received from Andrew Braiterman, Peter Connors, Stephen B. Land, David Miller, and Michael Schler. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("***NYSBA***") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unrelated Business Taxable Income Separately Computed for Each Trade or Business, REG-106864-18, 85 Fed. Reg. 23172 (Apr. 24, 2020).

[3] Unless otherwise indicated, all section references are to the Code and the Treasury regulations promulgated thereunder.

proposals in the Notice. Part IV contains a detailed discussion of our recommendations and requests.

II. Executive Summary

We generally endorse the approach of the Proposed Regulations and support the use of the NAICS two-digit code as well as the aggregation of investments in partnerships and S corporations that meet either a de minimis or control test. The rules set forth in the Proposed Regulations are generally administrable for exempt organizations and the IRS. Our most significant comments are directed at ensuring consistent results for effectively equivalent investments.

A summary of our principal recommendations and comments follows:

A. Use of NAICS Two-Digit Sector Codes

The Proposed Regulations generally require that business activities conducted directly by the exempt organization, or indirectly through a partnership that is not a QPI, be reported on the basis of twenty NAICS two-digit sector codes. We recommend that all exempt organizations that participate in the same unrelated trade or business through one or more pass-through entities be required to report that trade or business consistently.

In light of the prohibition on changing an NAICS code absent an unintentional error, Treasury and the IRS should clarify that exempt organizations are permitted to change the NAICS two-digit code with respect to a trade or business if the nature of the business has so evolved or shifted that another NAICS two-digit code more accurately describes the trade or business.

B. Allocation of Directly Connected Indirect Expenses

Treasury regulations section 1.512(a)-1(c) allows exempt organizations to allocate expenses as between an exempt activity and an unrelated business activity on any "reasonable basis"; the Proposed Regulations incorporate this standard for allocating expenses among multiple trades or businesses. We agree with the proposed any "reasonable basis" standard, which takes into account all facts and circumstances. We also believe that no method (including the unadjusted gross-to-gross method) should be deemed per se unreasonable.

C. Allocation of Net Operating Losses among Trades or Businesses

We recommend that Treasury and the IRS clarify the method of allocating pre-2018 NOLs among multiple trades or businesses and suggest two alternatives. We also recommend certain clarifications relating to NOLs the treatment of which is governed by the CARES Act.

D. Payments Affecting Controlled Partnerships

Under the Proposed Regulations, holding "debt-financed property" (within the meaning of section 514) is treated as an investment activity but holding interests in partnerships that are controlled entities within the meaning of section 512(b)(13)) is not. To prevent taxpayers from sidestepping the QPI framework, we recommend that the definition of "debt-financed property" be clarified to exclude debt-financed partnership interests that are also controlled entities.

E. Qualified Partnership Interests

1. Indirectly Held Partnerships

The look-through approach to partnership interests, and partnership activities, incorporated in the Proposed Regulations is very limited. We recommend expanding the scope of enumerated investment activities in Proposed Regulations section 1.512(a)-6(c)(1) to include owning "holding company partnership interests" (as defined below), whose sole activities would be investment activities (within the meaning of the Proposed Regulations) and other clearly non-UBTI generating activities. We also recommend that exempt organizations be required to look through certain partnerships that would otherwise be treated as QPIs to prevent tiered structures from being used to avoid the limitations on aggregating partnership interests.

We also recommend that Treasury and the IRS extend the requirement to aggregate partnership interests to interests that are owned by related persons within the meaning of section 267(b)(9) and to exempt organizations that are "controlled taxpayers" (as defined in the regulations to section 482), both of which invoke similar concepts of functional control. Moreover, we believe that it would be appropriate to extend this aggregation rule to determine (i) ownership under the control test, (ii) control under the control test, and (iii) whether an exempt organization is treated as a general partner of a partnership (or a managing member of a limited liability company treated as a partnership).

2. Control Test

The control test of the Proposed Regulations is satisfied if an exempt organization both (i) owns less than 20% of the capital interests of a partnership and (ii) does not control the partnership within the meaning of the Proposed Regulations. We generally support the control test as an administrable method of identifying QPIs, but recommend that Treasury and the IRS provide that the ownership threshold of the control test is satisfied if an exempt organization owns less than 20% of both the capital *and profits* interests of a partnership.

Further, although we endorse the Proposed Regulations' facts and circumstances approach to evaluate control, we do not believe that any of the four control rights enumerated in the Proposed Regulations should be treated as per se evidence of control. We also recommend that the final regulations adopt two additional refinements to the control prong to further the administrability of the facts and circumstances test: (1) the control rights in Proposed Regulations section 1.512(a)-6(c)(4)(iii)(A) should not include rights with respect to non-ordinary course actions, and (2) the final regulations should include a list of rights that are generally not indicative of control.

3. Other General Comments

Under the Proposed Regulations, a partnership interest is ineligible to be treated as a QPI if the exempt organization is a general partner of that partnership. There is little practical difference between a general partner and a managing member, and taxpayers are generally free to structure their investment vehicles as limited liability companies if they seek pass-through treatment. As a result, we recommend that Treasury and the IRS expand Proposed Regulations section 1.512(a)-6(c)(8)(ii) to apply to managing member interests, and disqualify from QPI treatment, a limited liability company classified as a partnership in which an exempt organization serves as a managing member.

To further the prompt and accurate compliance with the Proposed Regulations, we recommend that pass-through entities be required to report on Schedule K-1 of Form 1060 and Form 1120-S or, in some cases, to disclose on request, the information necessary to enable exempt organizations to comply with section 512(a)(6).

III. Summary of the Proposed Regulations

The Proposed Regulations adopt a series of rules that are intended to largely simplify both reporting by exempt organizations subject to tax and administration of the rules by the IRS. Generally, the Proposed Regulations permit grouping of similar activities into one broadly defined trade or business. In addition, the Proposed Regulations also permit exempt organizations to aggregate their passive investment activities that generate unrelated business income and treat them as a single unrelated business.

Under the Proposed Regulations, exempt organizations generally must identify each separate trade or business using the NAICS two-digit sector code that most accurately describes the unrelated trade or business,[4] rather than using the NAICS six-digit code system initially suggested in the Notice.[5] As the Preamble notes, there was considerable support for using the NAICS two-digit codes among commentators on the Notice. Moreover, also as noted in the Preamble, the use of the two-digit code facilitates compliance because each code describes a broad sector of the economy.

The Proposed Regulations also provide for three other ways of identifying income from unrelated trades or businesses. First, all of an exempt organization's "investment activities" are, collectively, treated as a single unrelated trade or business. Investment activities include an exhaustive list of permitted activities: holding (i) partnership interests designated as QPIs, described further below, (ii) S corporation interests designated as "qualifying S corporation interests",[6] and (iii) debt-financed properties (within the meaning of section 514).[7] Accordingly, income and deductions from all of the foregoing activities may be aggregated when calculating an exempt organization's UBTI derived from its investment activities.

Second, the Proposed Regulations address the classification of income derived from certain controlled entities.[8] The Proposed Regulations treat all specified payments received by a

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[4] The term "unrelated trade or business" generally refers to any trade or business the conduct of which is not substantially related to the exercise or performance by an exempt organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. *See* section 513(a). As described in the Preamble, what constitutes a "trade or business" is not defined in the Code, although generally the standards set forth in section 162 have been used as a reference. Treas. Reg. § 1.513-1(b).

[5] Prop. Treas. Reg. § 1.512(a)-6(b)(1). Currently, broad categories of business activities are represented by twenty NAICS two-digit sector codes. Representative sector codes include: Manufacturing (31-33), Retail Trade (44-45), Transportation and Warehousing (48-49), Finance and Insurance (52), Real Estate and Rental and Leasing (53), Educational Services (61), Health Care and Social Assistance (62), and Arts, Entertainment, and Recreation (71).

[6] Prop. Treas. Reg. § 1.512(a)-6(e)(2).

[7] Prop. Treas. Reg. § 1.512(a)-6(c)(1).

[8] Prop. Treas. Reg. § 1.512(a)-6(d).

controlling organization from a single controlled entity (within the meaning of section 512(b)(13)(D)) as a single, separate unrelated trade or business. If specified payments are received from multiple controlled entities, the payments received from one controlled entity are treated as a separate unrelated trade or business from specified payments received from another controlled entity, as well as any other trades or businesses reported by the exempt organization.[9] In addition, insurance income (within the meaning of section 512(b)(17)) that is derived from a controlled foreign corporation will be treated as derived from a separate unrelated trade or business.[10]

Third, income derived from stock in each S corporation (other than a "qualifying S corporation interest") will be treated as a separate unrelated trade or business.[11] Very generally, qualifying S corporation interests are S corporation interests that would satisfy the de minimis or control tests, described below, as if the S corporation were a partnership (a "***qualifying S corporation interest***").

As noted above, under the Proposed Regulations, taxpayers can aggregate UBTI realized from all partnership interests designated as QPIs as part of their trade or business in investment activities. An exempt organization cannot designate a partnership interest as a QPI if it is the general partner of that partnership.[12] However, it may otherwise designate a partnership interest as a QPI if, in the case of a directly held partnership interest, the exempt organization (i) owns no more than 2% of the capital and profits interests (the "***de minimis test***"),[13] or (ii)(x) owns, after taking into account certain related interests, no more than 20% of the capital interests, and (y) does not "control" the partnership (the "***control prong***" and, together with the requirement in clause (ii)(x), the "***control test***").[14] In addition, an indirectly held partnership interest that meets the requirements of the de minimis test may be designated as a QPI, but only if held through a directly held partnership in which the exempt organization owns more than a 20% capital interest but does not control (within the meaning of the Proposed Regulations) (the "***look-through rule***").[15]

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[9] Prop. Treas. Reg. § 1.512(a)-6(d)(1).

[10] Prop. Treas. Reg. § 1.512(a)-6(d)(2).

[11] Prop. Treas. Reg. § 1.512(a)-6(e).

[12] Prop. Treas. Reg. § 1.512(a)-6(c)(8)(ii).

[13] Prop. Treas. Reg. § 1.512(a)-6(c)(3).

[14] Prop. Treas. Reg. § 1.512(a)-6(c)(4). For this purpose, control is generally determined under a facts and circumstances test; however, the Proposed Regulations also enumerate four specific rights that are indicative of control: "(A) The organization, by itself, may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership; (B) Any of the organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time; (C) Any of the organization's officers, directors, trustees, or employees have rights to conduct the partnership's business at any time; or (D) The organization, by itself, has the power to appoint or remove any of the partnership's officers or employees or a majority of directors." Prop. Treas. Reg. § 1.512(a)-6(c)(4)(iii).

[15] Prop. Treas. Reg. § 1.512(a)-6(c)(2)(ii).

A transition rule allows an exempt organization to identify directly held partnership interests acquired before August 21, 2018 as a single trade or business. This rule applies even if that partnership, directly or indirectly, conducts multiple trades or businesses or the partnership interest would not otherwise meet the de minimis or control tests.[16] 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.[17] The transition rule applies through the first day of an exempt organization's first taxable year beginning after the publication date of the final regulations.[18]

Under the Proposed Regulations, all activity within a particular NAICS code must be aggregated. Thus, if a partnership interest is not a QPI (a "***non-QPI partnership***") and does not qualify for the transition rule, the exempt organization must analyze its allocations of partnership income on a look-thru basis, categorizing any partnership items that are UBTI attributable to a particular trade or business identified by NAICS code at the partnership level. Accordingly, if the exempt organization conducts multiple trades or businesses with the same NAICS code, either directly or indirectly through non-QPI partnerships, those activities are grouped together. The exempt organization will then aggregate the income and expenses attributable to both its directly and indirectly conducted activities under the same NAICS code to calculate its UBTI for that trade or business. Under the Proposed Regulations, an exempt organization can apply any "reasonable basis" to allocate expenses among its trades or businesses, other than the unadjusted gross-to-gross method.[19]

In respect of NOLs, the Proposed Regulations clarify that the NOL deduction for each unrelated trade or business is determined separately.[20] Furthermore, an exempt organization that has both NOL carryforwards from a taxable year beginning before January 1, 2018 ("***pre-2018 NOL carryforwards***") and NOLs or NOL carryforwards from a taxable year beginning after December 31, 2017 ("***post-2017 NOLs***") is subject to an ordering rule. In such case, the pre-2018 NOL carryforwards are deducted first against the exempt organization's "total UBTI" (i.e., the sum of the UBTI computed with respect to each of its separate unrelated trades or businesses). Then, any post-2017 NOLs are deducted against the separate unrelated trade or business that generated those NOLs. Finally, the Proposed Regulations also note that "[p]re-2018 NOLs are taken against the total UBTI . . . in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year."[21]

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[16] Prop. Treas. Reg. § 1.512(a)-6(c)(7)(i). In addition, the Proposed Regulations clarify that the transition rule applies even if an exempt organization's ownership percentage in the directly-held partnership changes. *Id.*

[17] Prop. Treas. Reg. § 1.512(a)-6(c)(7)(ii).

[18] Prop. Treas. Reg. § 1.512(a)-6(c)(7)(iii).

[19] Prop. Treas. Reg. § 1.512(a)-6(f); Prop. Treas. Reg. § 1.512(a)-1(c).

[20] Prop. Treas. Reg. § 1.512(a)-6(h)(1).

[21] Prop. Treas. Reg. § 1.512(a)-6(h)(2).

IV. Discussion

We support the approach of the Proposed Regulations that emphasizes simplicity and administrability in determining when activities constitute a separate trade or business and permitting exempt organizations to group or aggregate certain related activities. We believe that these rules represent a reasonable interpretation of the statute and provide guidance that imposes a reasonable compliance burden on exempt organizations and is administrable by the IRS.[22] Our comments and recommendations are addressed primarily at identifying potential abuses and ensuring that the Proposed Regulations reach consistent results based upon the underlying economic arrangement rather than merely changes in form.

A. Use of NAICS two-digit sector codes

An exempt organization is required to report each NAICS two-digit sector code only once, presumably at the time the business commences or in the first year to which the statute is applicable.[23] Once a trade or business is identified by a particular NAICS two-digit sector code, a taxpayer can only change that code by notifying the IRS and demonstrating both an unintentional error in choosing that code and that another sector code more accurately describes the trade or business.[24]

Generally, we support the significant simplification achieved by adopting the NAICS two-digit codes for identifying unrelated trades or businesses in the Proposed Regulations. By reducing the potential categories of trades or businesses from over 1,050 (under the six-digit NAICS code approach in the Notice) to twenty under the Proposed Regulations, the Proposed Regulations greatly facilitate the process of identifying unrelated trades or businesses, and the aggregation of income and expenses.[25] In addition, since the business sectors identified by the NAICS two-digit code are quite broad and business activity is unlikely to span multiple NAICS

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[22] We believe that these rules should be viewed in light of the general ability of exempt organizations to structure their unrelated business activities in a manner that avoids the statutory rules. Such organizations could simply choose to conduct such activities through a taxable corporate subsidiary.

[23] Prop. Treas. Reg. § 1.512(a)-6(b)(2). This rule will enable exempt organizations to expand or contract activities within a separate trade or business without further reporting. For example, a hospital system that operates multiple pharmacies may report all of the pharmacies under a single NAICS two-digit sector code (retail trade – 44), together with any other retail trades with the same two-digit sector code, as a single unrelated trade or business, aggregating income and deductions across all of those business activities.

[24] Prop. Treas. Reg. § 1.512(a)-6(b)(3).

[25] We note, however, that Treasury and the IRS have used the six-digit NAICS codes for other tax purposes. For example, exempt organizations are required to use six-digit NAICS codes to report certain types of revenue (including revenue from the services that serve as a basis of their exemption and miscellaneous revenue that does not fall within the other categories of reported revenue) on Form 990. In addition, exempt organizations are required to use six-digit NAICS codes to report their revenue on Form 990. Schedule K of Form 1120 instructs corporations to determine the activities from which a corporation derives the highest percentage of its total receipts based on a list of six-digit NAICS codes. Individuals that report profits and losses from a trade or business on Schedule C of Form 1040 are also required to list the six-digit NAICS code that best describes their principal business activity. Finally, before section 1031 was revised to apply only to real property, taxpayers used six-digit NAICS codes to determine whether depreciable tangible personal property was "like-kind property" and thus entitled to tax-free treatment under section 1031. We are not aware of any situations in which the Treasury and the IRS have previously adopted a NAICS two-digit code for tax purposes.

two-digit codes, the Proposed Regulations also further consistent reporting by all taxpayers conducting similar unrelated trades or businesses.

It is less clear, however, that identifying trades or businesses by the NAICS two-digit code is entirely consistent with Congress' intent. The legislative history of Section 512(a)(6) is limited, and the stated intent was simply to prevent "a deduction from one trade or business for a taxable year . . . to offset income from a different unrelated trade or business for the same taxable year."[26] No guidance was given as to how broadly (or narrowly) an unrelated trade or business should be defined.

Section 512(a)(6) is arguably based on a similar proposal put forward (but not enacted) in 2014 in connection with the Tax Reform Act of 2014.[27] At that time, Congress had identified a concern with "how colleges and universities were abusing the unrelated business income tax (UBIT) rules by using loss-generating business activities to shelter gain from profitable businesses."[28] The legislative history pointed to the 2013 IRS Report that highlighted the problematic ways in which dozens of colleges and universities used losses to reduce their UBTI. This was achieved primarily by (i) applying losses from activities that the IRS determined lacked a profit motive to shelter UBTI generated by profitable businesses, and (ii) by over-allocating indirect expenses to exempt activities.

Section 512(a)(6), however, is a blunt tool for addressing the *improper* use of losses in the manners previously identified by the 2013 IRS Report. It would not necessarily foreclose applying losses generated by businesses lacking a profit motive (so long as the exempt organization conducted other profitable activities within the same NAICS code); rather the IRS would still be obligated to challenge those losses under the general rules.[29] It should be noted, however, that Section 512(a)(6) may act as a catalyst to regulatory action with respect to the allocation of expenses as between exempt and non-exempt activities.

We recognize that using the NAICS two-digit codes is likely to enhance the ability of taxpayers to use losses as compared to using six-digit codes as provided in the Notice. This approach could result in the grouping of arguably very different unrelated trades or businesses. For example, pharmacy losses can shelter gift shop profits under the same NAICS two-digit sector code for retail trade (44). Moreover, exempt organizations generally can aggregate business activities within a single NAICS two-digit sector code, whether conducted directly by the exempt organization or indirectly through non-QPI partnerships, within a single NAICS two-digit sector code. Thus, income generated by a ski resort earned through a partnership that is not

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[26] Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st Sess., at 410 (2017); s*ee also* H.R. 1, Tax Cuts and Jobs Act, H.R. Rep. No. 115-466, at 545-48 (Dec. 15, 2017).

[27] Committee on Ways and Means, Majority Tax Staff Discussion Draft on the Tax Reform Act of 2014, WMCP 113-6, 113th Cong. 2nd Sess., at 153 (Feb. 26, 2014) ("Under the provision, a tax-exempt organization would be required to calculate separately the net unrelated taxable income of each unrelated trade or business. In addition, any loss derived from an unrelated trade or business could only be used to offset income from that unrelated trade or business . . . . Thus, losses generated by one unrelated trade or business could not be used to offset income derived from another unrelated trade or business.").

[28] *Id*. at 152; *see also* IRS Exempt Organizations, Colleges and Universities Compliance Report (Apr. 25, 2013) (examining and challenging reported UBTI of 34 institutions) (the "***2013 IRS Report***").

[29] See section 183.

designated as a QPI can be sheltered by the losses generated by the exempt organization's direct operation of a music concert venue under the same NAICS two-digit sector code for arts, entertainment, and recreation (71).

While this broad grouping may seem somewhat inconsistent with the notion of "separate businesses", we note that an exempt organization may achieve substantially the same result by conducting those unrelated businesses through a corporate subsidiary. In that case, the income and losses from each of the activities would be combined.[30] In light of this background, and given ambiguity as to how section 512(a)(6) serves its stated purpose, we believe that the identification of trades or businesses based on their NAICS two-digit codes provides a reasonable, practical and effective way to apply the statute simply while limiting the compliance burden to taxpayers.

1. Consistent Reporting Requirement

We recommend that all exempt organizations that are participants in the same unrelated trade or business through one or more pass-through entities be required to report that trade or business consistently. This would ensure consistency in reporting and preclude exempt organizations from selectively choosing NAICS two-digit codes in an effort to create tax benefits in their own respective circumstances. As a practical matter, this issue is most likely to arise only in the context of exempt organizations that conduct unrelated trades or businesses through a partnership or S corporation in which the exempt organization has either a substantial interest or participates in management.[31] Accordingly, as discussed further in Part IV(G)(1) below, consistent reporting would be furthered by requiring partnerships and S corporations to supply the NAICS two-digit codes with respect to their trades or businesses on Schedules K-1 to Form 1065 or Form 1120-S, as applicable, and requiring exempt organizations to report the NAICS two-digit codes reported by the pass-through entity (unless the exempt organization's interest in that partnership or S corporation is a QPI or qualifying S corporation interest).[32]

2. Changing NAICS Two-Digit Code

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[30] Operating in corporate form has a significant drawback when assets are sold; under section 512(b)(5), exempt organizations generally are not taxed on capital gains, even if the asset sold generated UBTI, while a non-exempt corporation would be taxed on those gains.

[31] If the exempt organization only holds an insubstantial interest in a partnership or S corporation that it does not control, the interest can be designated a QPI or qualifying S corporation interest, in which case all of the trade or business activities are treated as investment activities.

[32] A partnership is already required to list the six-digit NAICS code that best describes the activity from which it derives the largest percentage of its total receipts on line C of Form 1065, *U.S. Return of Partnership Income*. A rule requiring partnerships to provide this information would be helpful given the sometimes significant burden of obtaining information from partnerships, which we have discussed elsewhere. *See* New York State Bar Association Tax Section Report No. 1419, Report on Section 1446(f) Proposed Regulations (July 12, 2019) (noting difficulties in obtaining information from partnerships for purposes of complying with the certification requirements to fall within an exception to withholding under the proposed regulations under section 1446(f)); *see also* New York State Bar Association Tax Section Report No. 1314, Report on the Proposed Regulations on Partnership Built-In Losses (Dec. 15, 2014) (recommending that the final regulations address the practical issue faced by partners who hold "small" interests in partnerships, by allowing such partners to rely on information provided to them by the partnership as to asset value and, in certain cases, requiring partnerships to provide such information).

We recommend that Treasury and the IRS clarify that exempt organizations are permitted to change the NAICS two-digit code with respect to a trade or business if the nature of the business has so evolved or shifted that another NAICS two-digit code more accurately describes the trade or business.[33] The Proposed Regulations require a showing of an unintentional error to change the NAICS two-digit code once an exempt organization has identified an unrelated trade or business using a particular NAICS two-digit code.[34] We recognize that exempt organizations should not be permitted to change the NAICS code of a business to seek a better tax result. However, the breadth of the activities captured by a single two-digit code means that such tax-driven changes will be unlikely. Rather, a desire to change the NAICS two-digit code is more likely to be motivated by an actual change in circumstances that suggests that the exempt organization has effectively started a new trade or business. In these cases, the exempt organization should be able to report its business activity under a new NAICS two-digit code in the first Form 990-T filed after beginning that new business, just as it would for any other new business.

In addition, we request clarification on the process for changing the NAICS two-digit code. The Preamble provides that Treasury and the IRS anticipate that the instructions to the Form 990-T will be revised to describe how an exempt organization provides notice of an unintentional error for purpose of changing the NAICS two-digit code under Proposed Regulations section 1.512(a)-6(b)(3). The instructions should clarify that exempt organizations may change the NAICS two-digit code by providing notification to the IRS on Form 990-T (which must explain the reason, with any substantiating evidence if appropriate, for changing the NAICS two-digit code) and that such change would be effective starting with the taxable year for which the Form 990-T with the notification is filed, unless and until otherwise notified by the IRS that the change of the NAICS two-digit code was improper and disallowed.

B. Allocation of Directly Connected Indirect Expenses

We recommend that the government continue to permit taxpayers to allocate indirect expenses using any "reasonable basis", taking into account all facts and circumstances, as set forth in Treasury regulations section 1.512(a)-1(c). We further recommend that Treasury and the IRS not treat any particular method as per se unreasonable, but rather identify standards and circumstances under which any particular method may be determined to be unreasonable.

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[33] *See* Preamble, at 23175 (explaining the requirement to use the six-digit NAICS code that most accurately describes the business). For example, an exempt organization may be engaged in a manufacturing operation as well as a sales operation. If the organization changed its operation to engage third party manufacturers, then it would be appropriate to change its NAICS code.

[34] Prop. Treas. Reg. § 1.512(a)-6(b)(3). The Proposed Regulations do not require an exempt organization to designate a partnership interest as a QPI even if it qualifies as a QPI. Prop. Treas. Reg. § 1.512(a)-6(c)(2)(iii) (providing that an exempt organization "may designate" a partnership interest as a QPI). Although not entirely clear, the Proposed Regulations appear to permit an exempt organization to initially designate NAICS two-digit codes to trades or businesses conducted by a partnership owned by the exempt organization, and later designate that partnership interest as a QPI (assuming the requirements to be treated as a QPI can be met). However, once designated as a QPI, the exempt organization cannot change or revoke such designation until the partnership interest no longer qualifies as a QPI, at which time the trades or businesses conducted by the partnership must be identified using the appropriate NAICS two-digit codes. Prop. Treas. Reg. § 1.512(a)-6(c)(2)(iii).

Treasury regulations section 1.512(a)-1(c) allows taxpayers to allocate expenses, depreciation, and other deductions attributable to dual use facilities or personnel between an exempt activity and an unrelated business activity on any "reasonable basis."[35] The reasonableness of an allocation method depends on all the facts and circumstances.[36] The Proposed Regulations incorporate this standard for allocating expenses among separate unrelated trades or businesses (so as to calculate UBTI under section 512(a)(6)(A)).[37] We understand that Treasury and the IRS intend to issue guidance that may change the application of these rules.

However, Treasury and the IRS have raised concerns that permitting the use of the any "reasonable basis" approach will be difficult for the IRS to administer. Accordingly, the Proposed Regulations identify certain methods that are considered to be per se unreasonable. In particular, the Proposed Regulations treat the unadjusted gross-to-gross method as per se unreasonable.[38] In support of its position, the Preamble describes fact patterns in which a social club charges nonmembers a higher price than it charges members for the same good or service, and a ski school charges the general public more for lift fees than it charges its students. In both of these scenarios, the cost of providing the good or service to members versus nonmembers, or the cost of providing the ski lifts to students versus the public, should be largely the same. However, the gross-to-gross method in this case shifted more indirect expenses to the non-exempt activity. Under these facts, the IRS indicated that the unadjusted gross-to-gross method resulted in an unreasonable allocation of indirect expenses because the indirect expenses would be unjustifiably over-allocated to the non-exempt activity.[39] We agree that under these facts that method would be unreasonable. However, the gross-to-gross method could be reasonable under other fact patterns. For example, consider a university's use of its health club facilities. If the university were to charge students the same fees as the public, a method allocating indirect costs based on total fees collected would seem reasonable.

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[35] Treas. Reg. § 1.512(a)-1(c) ("The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant provisions of the Code.").

[36] Preamble, at 23177 (citing *Rensselaer Polytechnic Institute v. Comm'r*, 79 T.C. 967 (1982), *aff'd* 732 F.2d 1058 (2d Cir. 1984) (finding that allocation of fixed indirect fieldhouse expenses (e.g., depreciation and overhead) between exempt and non-exempt uses on basis of actual use was "reasonable" within the meaning of Treasury regulations section 1.512(a)-1(c)).

[37] Prop. Treas. Reg. § 1.512(a)-6(f).

[38] Prop. Treas. Reg. § 1.512-1(a)-1(c). We note that gross-to-gross allocation method was considered by the Supreme Court in *Portland Golf Club*, in the context of an exempt social club using losses incurred in profit-motivated sales to nonmembers to offset investment income in computing UBTI. 497 U.S. 154 (1990). The social club in *Portland Golf Club* allocated the indirect costs between member and nonmember sales according to the "gross-to-gross" allocation method, which had the effect of the nonmember activities resulting in losses even though the gross income from nonmember sales exceeded the direct expenses incurred each year. The Supreme Court held that in determining whether a social club's nonmember activities were undertaken with a profit motive, the social club must allocate the indirect costs between member and nonmember sales according to the same method used to compute its actual profit or loss.

[39] Preamble, at 23178.

Because of the myriad different circumstances in which allocation of expenses may be required, we urge that Treasury and the IRS continue to permit allocating expenses on any "reasonable basis" (as set forth in Treasury regulations section 1.512(a)-1(c)). As under current law, the determination would be made considering all relevant facts and circumstances and the allocation method chosen should clearly reflect income.[40] We believe that the standard should be whether the allocation method clearly reflects income with regard to the businesses or activities involved, which would require considering all facts and circumstances, including whether an exempt organization is allocating expenses between exempt and non-exempt activities, or between multiple non-exempt activities. Because an allocation method that could be reasonable in one circumstance could be unreasonable in others, we do not believe that any allocation method should be treated as per se unreasonable or reasonable.

For example, an exempt organization could make multiple commingled fund investments, some of which are aggregated as part of the organization's investment activities (within the meaning of Proposed Regulations section 1.512(a)-6(c)(1)) and some of which are reported as separate unrelated businesses because the interests in the partnerships that conduct those unrelated businesses do not qualify as QPIs. If a manager oversees these various fund investments, we believe the exempt organization could allocate the expense of the manager's salary between the investment activities and the other unrelated businesses on the basis of various measures, any one of which could be reasonable depending on the context, including the relative values of the fund investments, amounts invested in each fund, net income generated by each fund, or time spent by the manager.

In other circumstances, each of those methods could also be unreasonable. For example, if the manager is spending substantially all of its time overseeing a directly conducted activity that is generating losses, such as research and development of new technology, and also overseeing investments in QPIs that generate net income, it would seem unreasonable to allocate the manager's expenses based upon the net income generated. In such a case, the allocation may be better based upon time spent.

Accordingly, we recommend that no particular method should be treated as per se unreasonable. Instead, the regulations should identify circumstances under which using a particular method would be viewed as unreasonable (e.g., if different prices are charged for the same good or service depending on whether that good or service is offered as part of its exempt or non-exempt activities). Any such regulations (whether proposed or final) should provide a number of examples illustrating application of the principles.

We understand that Treasury and the IRS believe that a reasonableness standard is difficult for the IRS to administer and lacks certainty for taxpayers.[41] However, in several other situations, the IRS administers (and taxpayers successfully account for) allocation rules that rely on a reasonableness determination. This arises, for example, in connection with section 1411, section 199A, and section 162, all of which use a reasonableness standard for allocating expenses

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[40] This standard is consistent with determining the method of accounting under section 446(b) in situations where no method of accounting is regularly used by the taxpayer.

[41] Preamble, at 23177.

among different activities or income.[42] The Preamble notes that Treasury and the IRS intend to publish a separate notice of proposed rulemaking providing further guidance on this allocation issue. In light of the language in the Preamble and the current Proposed Regulations, we strongly urge Treasury and the IRS to provide in that interim guidance that the taxpayers may continue to rely on the reasonableness standard under Treasury regulations section 1.512(a)-1(c) until the relevant regulations are finalized.

C. Allocation of Net Operating Losses among Trades or Businesses

We recommend that Treasury and the IRS address the specific methodology for the use of NOL carryovers. The interaction between pre-2018 NOL carryforwards and post-2017 NOLs involves some complexity as to which more detailed guidance should be provided. We suggest below some approaches without making a specific recommendation.

An exempt organization may deduct NOLs from a taxable year beginning before January 1, 2018 against its total UBTI calculated under section 512(a)(6)(B) in a given tax year.[43] However, under section 512(a)(6), NOLs from a taxable year beginning after December 31, 2017 may only be deducted against the UBTI of the separate unrelated trade or business to which such post-2017 NOL carryforwards relate.

The Proposed Regulations provide an ordering rule that requires exempt organizations with both pre-2018 NOL carryforwards and post-2017 NOLs to first apply the pre-2018 NOL carryforwards before using the post-2017 NOLs.[44] Proposed Regulations section 1.512(a)-6(h)(2) states that pre-2018 NOL carryforwards are taken into account "in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year", but does not provide more specific guidance on how the pre-2018 NOL carryforwards should be allocated among the various unrelated trades or businesses when deducted against total UBTI.[45]

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[42] *See* Treas. Reg. § 1.1411-4(g)(1) (permitting taxpayers to use any reasonable method to allocate expenses between net investment income and excluded income); Treas. Reg. § 1.199A-3(b)(5) (applying a reasonable method standard for purposes of allocating "qualified business income" between multiple trades or businesses that the taxpayers conducts directly); and Treas. Reg. § 1.162-28(b)(1) (allowing taxpayers to use any reasonable method to allocate their costs between their lobbying activities and other activities).

[43] H.R. 1, Tax Cuts and Jobs Act, H.R. Rep. No. 115-466, at 118 (Dec. 15, 2017). Although not codified, this Congressional report on the TCJA provides that section 512(a)(6) will not apply to pre-2018 NOL carryforwards.

[44] Prop. Treas. Reg. § 1.512(a)-6(h)(2); *see also* Preamble, at 23190. We recognize that this will give exempt organizations an opportunity to maximize the use of pre-2018 NOL carryforwards, which are subject to a 20-year carryforward limitation, unlike post-2017 NOLs (which may be carried forward indefinitely).

[45] Under the Proposed Regulations it is clear that an unrelated business with a current-year loss is to be ignored for the purpose of allocating the pre-2018 NOL carryforwards. For example, Business A has $200 of UBTI and Business B has ($150) of a current year loss in 2020, and the exempt organization that owns both businesses has pre-2018 NOL carryforwards of ($200). "Total UBTI" is defined under Proposed Regulations section 1.512(a)-6(g) as "the sum of the UBTI computed with respect to each separate unrelated trade or business"; under Proposed Regulations section 1.512(a)-6(g)(2), losses are not taken into account. The exempt organization's "total UBTI" (within the meaning of Proposed Regulations section 1.512(a)-6(g)) in 2020 is $200 (from Business A), plus $0 (from Business B).

The ordering rule requires applying pre-2018 NOL carryforwards before the use of post-2017 NOLs, and, therefore, the application of pre-2018 NOL carryforwards would always be maximized regardless of how the carryforwards are allocated among the exempt organization's unrelated trades or businesses. However, the relative allocation of pre-2018 NOL carryforwards among multiple trades or businesses would impact the use of post-2017 NOLs. The final regulations should clarify the methodology or principle that should be used to allocate the pre-2018 NOL carryforwards among unrelated trades or businesses.

We have identified two methods that, consistent with both the general rule that NOLs are generally applied chronologically and the approach in the Proposed Regulations, could serve as a reasonable basis for allocating the pre-2018 NOL carryforwards among an exempt organization's unrelated trades or businesses.[46] Under one method (the "***gross allocation method***"), an exempt organization would allocate the pre-2018 NOL carryforwards *pro rata* among its unrelated trades or businesses based on their respective positive UBTI (before taking into account any potential post-2017 NOLs).

Under a second method (the "***net allocation method***"), the pro rata allocation of the pre-2018 NOL carryforwards among the unrelated trades or businesses would generally be based on their respective positive UBTI (determined, however, after tentatively taking into account any post-2017 trade or business-specific NOLs). However, if any pre-2018 NOLs carryforwards remained after that allocation, then the balance would be allocated to each business in proportion to its remaining gross UBTI (without regard to the post-2017 NOLs). The following example illustrates these methods:

> Example 1. H is an exempt hospital organization that conducts two unrelated businesses. In 2020, H has aggregate UBTI of $250 from the two businesses before taking into account any loss carryforwards – $100 from Business A and $150 from Business B. H also has 2016 NOL carryforwards of ($150). Business A has not generated any NOLs since 2016. Business B has 2019 NOLs of ($150). In accordance with the ordering rule, the 2016 NOL carryforwards of ($150) are first deducted from H's aggregate UBTI of $250.

Under the gross allocation method, the 2016 NOL carryforwards of ($150) would be allocated ($60) to Business A (which had 40% of the total UBTI) and ($90) to Business B (which had 60% of the total UBTI, *before* taking into account Business B's potential use of its 2019 NOL). As a result of this allocation, Business A would have taxable income of $40. Business B would have $60 of UBTI after applying the pre-2018 NOL (all of which would be sheltered by its 2019 NOL) and would have ($90) of the 2019 NOL to carryforward to future years.

Under the net allocation method, the 2016 NOL carryforwards of ($150) would be allocated ($100) to Business A (which had 100% of the total UBTI, *after tentatively* taking into account Business B's potential use of its 2019 NOL) and ($0) to Business B (which had none of

[46] *See* section 172(b)(2); Prop. Treas. Reg. § 1.512(a)-6(f).

the total UBTI, *after tentatively* taking into account Business B's potential use of its 2019 NOL). After this initial allocation of the 2016 NOL carryforwards of ($100) to Business A, ($50) of the 2016 NOL carryforwards would remain, and would then be allocated ($0) to Business A and ($50) to Business B, in proportion to their respective gross UBTI remaining without regard to any post-2017 NOLs. Business B would then use ($100) of its 2019 NOL. As a result, neither Business A nor Business B would have any UBTI, but Business B would have a ($50) 2019 NOL carryforward remaining to carry over to 2021 and later years.

Under each alternative, the full pre-2018 NOL carryforwards would be used. The gross allocation method would seem the more straightforward approach—simply allocating pre-2018 NOL carryforwards pro rata based upon each businesses UBTI. The net allocation method, however, would offer taxpayers the opportunity to maximize the use of both pre-2018 NOL carryforwards and post-2017 NOLs in any given tax year, and with a formulaic approach.

A third alternative that we have considered would be to permit taxpayers to employ any reasonable method to allocate the pre-2018 NOLs. For example, under this approach, the taxpayer could allocate all of the 2016 NOL carryforwards to Business A in order to maximize the use of Business B's 2019 NOLs. Such an approach would almost always insure maximum NOL usage. However, we are concerned that this amount of discretion would encourage unwarranted manipulation of other deductions and expenses. Accordingly, we would not endorse such an approach, but would urge Treasury and the IRS to consider one of the other methods.

Finally, we note that the CARES Act amended section 172 to provide that NOLs arising in 2018, 2019, and 2020 (any such NOLs, "***CARES Act NOLs***") can be carried back up to five taxable years, and be carried forward and fully offset taxable income in future years (without being subject to the 80 percent income limitation).[47] On June 8, 2020, Treasury and the IRS issued a set of frequently asked questions addressing the interaction of the CARES Act and the allocation of NOLs under section 512(a)(6).[48] It would be helpful for the IRS to clarify that, in respect of post-2017 NOLs, exempt organizations can elect to waive the NOL carryback under section 172(b)(3) on a business-by-business basis.

We believe this is supported by the statutory language under section 512(a)(6), which provides that UBTI, "including for purposes of determining *any* net operating loss deduction", is computed separately for each trade or business. Section 172(b)(3) also describes the carryback

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[47] The Coronavirus Aid, Relief, and Economic Security Act, 77 Public Law 116-136, 134 Stat. 281 (2020) (the "***CARES Act***"), temporarily repeals the rule limiting the NOL deduction to 80% of taxable income and permits the carryback of NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the taxable year of such loss.

[48] IRS, FAQs—Carryback of NOLs by certain exempt organizations, https://www.irs.gov/newsroom/faqs-carryback-of-nols-by-certain-exempt-organizations (last updated June 8, 2020). This guidance generally clarifies that (i) CARES Act NOLs are post-2017 NOLs that are calculated on a business-by-business basis and, except as described in clause (iii), are subject to the silo requirements; (ii) as a result, for post-2017 tax years, CARES Act NOLs may not be deducted against aggregate UBTI (and only offset income from the same trade or business generating that NOL); and (iii) for tax years beginning before January 1, 2018, when section 512(a)(6) did not apply, CARES Act NOLs may be deducted against aggregate UBTI.

waiver as applying to "*a* net operating loss" for any tax year. Further, under the Proposed Regulations, for post-2017 NOLs, the 80% of income limitation applies on a business-by-business basis.[49] This implies that an NOL generated by an unrelated trade or business should be viewed as a separate NOL, and a carryback waiver should be available separately for each unrelated trade or business. Finally, this interpretation is also consistent with the IRS's determination that a carryback waiver election in the context of certain NOLs did not result in the waiver of the carryback for other NOLs.[50]

Moreover, although the guidance did not specifically address this point, we assume that, consistent with the standard first-in-first-out priority principle of applying NOLs, losses subject to a two-year carryback (e.g., 2017 NOLs that can be carried back through 2015) would apply before losses subject to a five-year carryback (e.g., 2019 NOLs that can be carried back through 2014) for any years in which both NOLs would apply (here, 2015, 2016 and 2017).[51] However, the manner of allocating carrybacks for multiple post-2017 CARES Act NOLs (i.e., an NOL in respect of Business A and an NOL in respect of Business B, both of which were generated in 2020) remains unclear.

D. Provisions Affecting Controlled Partnerships

First, we request clarification that a partnership that is a controlled entity as defined in section 512(b)(13)(D) (a "***controlled partnership***") that is debt-financed by an exempt organization, and therefore treated as "debt-financed property" (within the meaning of section 514) should not be so treated for purposes of determining the scope of that exempt organization's

[49] Proposed Regulations section 1.512(a)-6(h)(1) provides that "an exempt organization with more than one unrelated trade or business *determines the NOL deduction allowed by sections 172(a) and 512(b)(6) separately with respect to each of its unrelated trades or businesses*." The 80% limitation for using post-2017 NOLs is codified in section 172(a)(2)(B)(ii); hence, the separately computed NOL deduction for a trade or business takes that limitation into account on a business-by-business basis. Finally, the Proposed Regulations further provide that Treasury regulations section 1.512(b)-1(e), which provides that UBTI is reduced by the NOL deduction (which, in turn, already incorporates the 80% limitation), applies separately for each unrelated trade or business.

[50] *See, e.g.,* Section 172(f)(6) (2016) (pre-TCJA statute permitted taxpayers to waive the carryback period for specified losses); *see also* Treas. Reg. § 1.172-13(c)(4) (election to relinquish carryback period for NOL generally does not preclude carryback of product liability loss); PLR 9444020 (election by consolidated group to relinquish 3-year carryback for consolidated NOL did not also require it to give up 10-year carryback associated with its specified liability loss, relating to product liability losses and deferred statutory or tort liability losses).

[51] Treas. Reg. § 1.172-4(a)(3) ("For the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss 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.").

investment activities under the Proposed Regulations.[52] This would result in the activities of the controlled partnership being treated as a separate trade or business under the general rule.[53]

Under Proposed Regulations section 1.512(a)-6(c)(1)(iii), an exempt organization's "investment activities" include "[d]ebt-financed property or properties (within the meaning of section 514)".[54] Accordingly, income from these debt-financed properties are generally aggregated with the UBTI derived from the exempt organization's other investment activities (i.e., QPIs and qualifying S corporation interests).

Absent this clarification, as the examples below illustrate, the Proposed Regulations would incentivize an exempt organization to finance its interest in a controlled partnership:

> Example 2: H, an exempt organization, controls and owns 99% of the capital and profits of a partnership (CP) that operates two separate unrelated operating trades or businesses (Business A and Business B) that each fall under separate NAICS two-digit codes. H capitalized CP with $100 of equity, all of which was funded with H's existing cash reserves. In Year 1, CP generates (i) $100 of net income from Business A, and (ii) a ($200) loss from Business B.

Because CP is a controlled partnership, H's interest in CP does not qualify as a QPI and cannot be treated as part of H's "investment activities". As a result, H must separately take into account UBTI from Business A and the loss from Business B in accordance with their respective designated NAICS two-digit codes, and the loss generated by Business B is not available to offset the income generated by Business A (or any other trade or business conducted by H, other than a business under the same NAICS two-digit code).

> Example 3: H borrows $100 to acquire an interest in CP. In Year 1, CP generates $100 of net income from Business A and ($200) of loss from Business B.

Again, CP is not a QPI. However, CP is "debt-financed property" within the meaning of section 514 that may be treated as part of H's "investment activities" under Proposed Regulations section 1.512(a)-6(c)(1)(iii).[55] The Proposed Regulations indicate that merely

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[52] Preamble, at 23184 ("[T]he proposed regulations include all the UBTI under section 512(b)(4) from an exempt organization's debt-financed property or properties (and not just its unrelated debt-financed income arising in connection with a QPI as provided in Notice 2018–67) in the list of 'investment activities' treated as a separate unrelated trade or business for purposes of section 512(a)(6).").

[53] This result would be consistent with the rule in section 514(b)(1)(B) which treats income from debt financed property that is derived in an unrelated trade or business as income from that activity rather than as debt financed.

[54] For this purpose, "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year. Section 514(b).

[55] Under section 514(c), "acquisition indebtedness" includes "the indebtedness incurred by the organization in acquiring or improving such property".

holding debt-financed property would result in all of the income from that debt-financed property being aggregated as part of the exempt organization's investment activity trade or business. Accordingly, the loss from Business B is aggregated with the income from Business A (as well as with any of H's other investment activity income).

We do not believe it is appropriate to allow, effectively, an exempt organization to elect into reporting UBTI from its controlled partnership as part of its investment activities trade or business or by the NAICS codes, depending on whether the partnership interest was debt financed. This would essentially allow exempt organizations to sidestep the rules that disallow interests in a controlled partnership from qualifying as QPIs.[56] Moreover, as Treasury and the IRS believe that "the required degree of control" exercised by an exempt controlling organization over a controlled partnership means that the controlled partnership is "not a part of the controlling organization's otherwise appropriately characterized investment activities", financing that controlled partnership with debt does not justify a different result.[57] We believe that carving out controlled partnerships from debt-financed property that may be treated as part of an exempt organization's investment activities would address the concerns laid out above.

Second, we note that, under the Proposed Regulations, all of the specified payments (i.e., interest, annuities, royalties, and rents) made by a controlled partnership to its controlling exempt organization are treated as UBTI from a single, separate unrelated trade or business that is not part of its investment activities.[58] According to the Preamble, the plain language of section 512(b)(13) arguably requires that each specified payment be treated as its own unrelated trade or business "because section 512(b)(13) requires an exempt organization to include such payment as an item of gross income derived from 'an' unrelated trade or business."[59] However, citing administrative burdens on hospitals and other controlling organizations that receive many specified payments, the approach in the Proposed Regulations aggregates multiple specified payments from a single controlled entity as UBTI from a single trade or business.

We do not make any specific recommendations on this point, but want to highlight an unexpected result in connection with specified payments paid by a controlled partnership operating a loss-generating business. Consider the following example:

> Example 4. EO owns 99% of a controlled partnership (CP). CP's sole activity is a research and development business, reported under NAICS code 54. CP pays EO $100 rent for office space. Its NOLs for the year, including the rental expense, are ($400).

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[56] Preamble, at 23180.

[57] Preamble, at 23185.

[58] Prop. Treas. Reg. § 1.512(a)-6(d)(1). If our recommendation in Part IV(F)(1)(i) (regarding holding company partnership interests) is adopted, we believe this should continue to be the rule for specified payments received by an exempt organization from any controlled entities held through holding company partnership interests.

[59] Preamble, at 23185.

Under the Proposed Regulations, the $100 of rental income is a specified payment that is treated as income to the exempt organization from one unrelated trade or business. CP also allocates the ($396) of the NOLs to the exempt organization, but this is a loss in respect of a different business reported under the NAICS code. Accordingly, the exempt organization's allocable share of the rental expense cannot largely offset the rental income received as a specified payment. By contrast, prior to the enactment of the silo requirement in section 512(a)(6), the exempt organization would have been allocated a net loss of ($296) in respect of the business, attributable to $100 of rental income, ($99) of allocable rental expense, and the remaining ($297) NOL. The income and loss would have all been treated as part of the exempt organization's aggregate UBTI and the allocable rental expense would have largely offset the rental income received by that organization.

Section 512(b)(13) was intended to eliminate the abuse associated with a controlled entity paying deductible interest, rents, royalties, or other specified payments "in sufficient amount to eliminate their entire income, which interest, rents, and royalties are not taxed to the parent even though they may be derived from an active business."[60] Congress solved the issue by adding back these amounts to a controlling exempt organization's UBTI. However, the Proposed Regulations now create a deduction mismatch that puts taxpayers at a disadvantage relative to the operation of section 512(b)(13) in prior years.

There are alternative approaches that could mitigate these adverse effects in the case of controlled partnerships. First, rather than treating the specified payment as UBTI from a separate, unrelated trade or business, exempt organizations could trace the specified payment to the underlying business or businesses that generated the deduction. For a controlled partnership that operates a single trade or business, all of the specified payments would be treated as UBTI associated with that same NAICS code designated to such trade or business. This treatment aligns with the view of Treasury and the IRS in the Preamble that the payments from controlled entities are from "an" unrelated trade or business.[61] Moreover, in accepting that view, when all of a controlled entity's trade or business activity falls within a single NAICS code, it seems reasonable to treat a specified payment received from that controlled entity as received in respect of the entity's business.

Moreover, even if a controlled partnership operated multiple trades or businesses, we expect that a specified payment could often be associated with a related business with little incremental effort. Finally, to the extent tracing among multiple trades or businesses is required, this should be no different than similar tracing employed by exempt organizations in, for example, allocating acquisition indebtedness among multiple assets, or allocating indirect expenses among multiple businesses, as described in Part IV(B) above.

Notwithstanding the above alternatives, the deduction mismatch created by the Proposed Regulations may be the necessary result of changing the manner of calculating UBTI generally.

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[60] Tax Reform Act of 1969, H.R. Rep. No. 91-413 (Part 1), at 49 (1969).

[61] *Id.*

Although we do not advocate for any method in particular, we urge Treasury and the IRS to consider whether some mitigation is appropriate.

E. Other Debt-Financed Property Considerations

We have two technical recommendations to the definition of "debt-financed property", which is defined in the Proposed Regulations by reference to section 514. With limited exceptions, section 514(b)(1)(C) excludes "any property to the extent that the income from such property is taken into account in computing the gross income of *any unrelated trade or business*" from the definition of debt-financed property. However, debt-financed property under Proposed Regulations section 1.512(a)-6(c)(1)(iii) would be taken into account in computing income associated with a taxpayer's investment activity unrelated trade or business. As such, the cross-reference to section 514 is circular. We recommend that "Debt-financed property or properties (within the meaning of section 514 (other than section 514(b)(1)(C))" replace the existing corresponding language in the Proposed Regulations.

In addition, we believe that "debt-financed property" should exclude debt-financed property used in connection with a trade or business that is reported under an NAICS two-digit code by the exempt organization. In that case, it would be more appropriate for any income generated in respect of such property to be aggregated only with the other income reported under that NAICS two-digit code (and not with the exempt organization's investment activities generally).

F. Qualified Partnership Interests

We generally support the QPI framework described in the Proposed Regulations, which allows an exempt organization to identify certain partnership interests as QPIs and aggregate income (and directly connected deductions) derived from those QPIs with its other investment activities as one trade or business under section 512(a)(6). We understand the need for, and support, rules that are administrable for both taxpayers and the government. Our recommendations to the QPI framework identify situations in which, by permitting more aggregation with relatively little added administrative complexity, the calculation of UBTI would better comport with the economic substance of an exempt organization's investments. Our recommendations also target abusive opportunities in which, by changing the form of a transaction, a taxpayer could aggregate non-investment trade or business activities with its investing activity UBTI. Finally, we make additional recommendations to the rules relating to combining interests, the implementation of the control test, and other operational rules relating to QPIs.

1. Indirectly Held Partnerships

We are primarily concerned with how the QPI rules apply in the context of indirectly held partnerships. When calculating a taxpayer's income tax liability, with few exceptions, aggregate principles of Subchapter K (i.e., the idea that a partnership is merely an aggregate of its partners and each partner owns an undivided interest in the partnership assets and operations)

generally govern the taxation of partnership income.[62] The limited look-through rule, by contrast, means that the Proposed Regulations often treat a partnership as an entity to identify QPIs and provide rules for calculating an exempt organization's UBTI. These are fundamental to the question of whether, and to what extent, income derived by an exempt organization partner is taxed. Although we understand that the QPI rules are rules of administrative convenience, as discussed below, we believe that, in some instances, Treasury and the IRS could hew closer to taxing exempt organizations on an aggregate (or look-through) basis, without sacrificing much of the simplicity of the QPI framework.

i. Expand the look-through approach to holding company partnership interests

We recommend that the look-through approach to aggregating investment activity income be expanded to include income derived from "holding company partnership interests" (as defined below) whose sole activities are investment activities (within the meaning of the Proposed Regulations). We believe this could be efficiently achieved by expanding the list of investment activities in Proposed Regulations section 1.512(a)-6(c)(1) to include holding a holding company partnership interest.

The Proposed Regulations apply a look-through approach to aggregating investment activity income in very limited circumstances. The look-through rule provides that an indirectly held partnership interest may be designated as a QPI only if (i) the exempt organization holds the partnership interest through a directly held partnership in which it owns more than 20% of the partnership's capital interests but does not control (within the meaning of Proposed Regulations section 1.512(a)-6(c)(4)(iii)), and (ii) the indirectly held partnership interest satisfies the de minimis test (i.e., the exempt organization holds no more than 2% of the capital and profits interest in that partnership, taking into account only the ownership interest held through the directly held partnership described in clause (i)).[63]

Limitations in the look-through rule prevent the aggregation of income from activities that, in substance, are similar or identical to those investment activities that may be aggregated under the Proposed Regulations. The de minimis limitation in clause (ii) prevents exempt organizations from designating as QPIs interests of indirectly held partnerships that, if held

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[62] Most fundamentally, a partnership is not treated as a taxable entity; instead its partners in their individual capacities are liable for paying income tax attributable to the operations of the partnership. Section 701. Partners must report their allocable share of partnership items of income and gain on their own returns, even if the partnership does not make distributions. Similarly, partners are required to report partnership items of loss and deduction on their own returns. Section 702(a). Partners also take into account their share of partnership liabilities. Section 752(a). Furthermore, transfers of property between a partner and partnership generally do not result in the recognition of gain or loss by the partner or the partnership. However, there are some rules under subchapter K that are based on an entity theory of partnerships (i.e., the view that a partnership owns its assets and conducts its operations, and the partners participate indirectly through the entity), including the rules for accounting for partnership operations and determining the amount, character and timing of partnership items. Sections 702 and 703. The entity approach also underpins many of the rules addressing a partner's exit from a partnership. When a partner disposes of a partnership interest, the partner is generally required to recognize the amount of gain or loss determined by its outside basis (i.e., the partner's basis in its partnership interest), rather than the partnership's inside basis (i.e., the basis of the partnership assets).

[63] Prop. Treas. Reg. § 1.512(a)-6(c)(2)(ii). Ownership is determined by reference to direct or indirect ownership, but the only indirect ownership that is relevant is via the look-through rule. Prop. Treas. Reg. § 1.512(a)-6(c)(3).

directly, would qualify as QPIs under the control test. In other words, if an exempt organization owns more than 2% (but 20% or less) of a partnership that it does not control, the contribution of that partnership interest to, or the ownership of that partnership interest through, *any* upper-tier partnership (whether or not controlled by the exempt organization) will eliminate its ability to treat the associated UBTI as investment-related.

Moreover, the look-through rule is not available at all if an exempt organization controls the upper-tier partnership (within the meaning of Proposed Regulations section 1.512(a)-6(c)(4)(iii)).[64] This effectively precludes a tax-conscious exempt organization from maintaining partnerships as holding companies. These partnerships are commonly formed by large exempt organizations to facilitate the ownership and administration of their minority holdings in various partnerships. The look-through rule could essentially force an exempt organization to hold these minority interests directly to treat them as QPIs, even though interposing a holding company in no way changes the investment nature of these minority interests.

Although partnerships that operate as holding companies may conduct a range of activities for which a look-through approach could be appropriate as a policy matter, that approach is inconsistent with the goals of the QPI framework. Treasury and the IRS noted in the Preamble that "the de minimis and control tests are rules of administrative convenience" and declined to adopt certain proposed recommendations that would require additional "safeguards and limitations that would complicate the rule and place additional administrative burdens on exempt organizations."[65]

To balance these concerns, we propose extending the look-through approach to an exempt organization's ownership of "***holding company partnership interests***": any directly held partnership interests if the partnership's sole activities are comprised of one or more of the following activities: (i) owning partnership interests that would be treated as QPIs if held by the exempt organization directly, (ii) holding assets that generate solely income that is not treated as UBTI under section 512(b)(1) and (iii) conducting, directly or indirectly through any pass-through entities, any other activity that is treated as an investment activity under Treasury regulations section 1.512(a)-6(c)(1) as finalized.[66] By drawing the line narrowly, an exempt organization could only designate a partnership as a holding company partnership interest if all of the partnership's activities (including those conducted through lower-tier partnerships) would have qualified as investment activities (within the meaning of the Proposed Regulations) had they been conducted directly by that exempt organization. Moreover, with this rule, we intend

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[64] Although the Proposed Regulations do not specifically state that a taxpayer cannot look through an upper-tier entity in which the exempt organization is a general partner, we believe the general partner would be deemed to have the control described in Proposed Regulations section 1.512(a)-6(c)(4)(iii)(A).

[65] *Cf.* Preamble, at 23183 (declining to adopt certain recommendations that would permit taxpayer to hold greater percentage interests, if increase was for reasons beyond its control).

[66] Clause (iii) of this definition would permit a holding company partnership to hold an interest in a controlled partnership that, itself, only holds QPIs. To avoid any ambiguity about whether the specified payments paid by a controlled partnership that is held through a holding company partnership interest are treated as income from a separate trade or business (or aggregated as part of the exempt organization's investment activity trade or business), we recommend that Proposed Regulations section 1.512(a)-6(c)(1) cross-reference the specified payment rule in Proposed Regulations section 1.512(a)-6(d)(1).

that both controlling interests, including as a general partner or managing member, and non-controlling interests in holding company partnerships should be eligible for this treatment.[67]

We acknowledge that, on a going forward basis, taxpayers may be able to make a cost-benefit determination as to whether the holding company structure (and the associated administrative and structural simplicity) is appropriate for its new investments. However, taxpayers that have already invested in such structures may not be able to easily reorganize their holdings. An exempt organization theoretically can often—but not always—receive a distribution of interests in a lower-tier partnership at no tax cost to the partnership or the exempt organization.[68] As a practical matter, however, non-controlling partners of both operating partnerships and investment funds rarely, if ever, have the right to demand a redemption or withdrawal. Under these circumstances, where the decision to designate a partnership as a QPI is elective, we do not foresee many exempt organization partners successfully making such a request.

ii. Application of the look-through rule for S corporation interests

We also request clarification as to whether and, if so, to what extent, the look-through rule applies to indirectly held partnership interests owned through a qualifying S corporation interest. Under the Proposed Regulations, stock in an S corporation is generally treated as an interest in a separate unrelated trade or business.[69] However, if a directly held S corporation would otherwise meet the de minimis or control tests as if the S corporation were a partnership, the qualifying S corporation interest can be treated as part of the exempt organization's investment activities.

By its terms, the look-through rule applies only to certain indirectly held partnership interests held through a directly held *partnership*. The Preamble, however, notes that "the look-through treatment of an S corporation is similar to the look-through treatment of a partnership," although it does not reference the look-through rule in particular.[70]

2. Combining partnership interests

Under Proposed Regulations section 1.512(a)-6(c)(4), an exempt organization only takes into account the interests owned by supporting organizations (as defined in section 509(a)(3)) and controlled entities (under section 512(b)(13)) (together, the "***related interests***") to determine whether it owns partnership interests in excess of the 20% ownership threshold under the control

[67] Proposed Regulations section 1.512(a)-6(c)(8)(ii) currently applies only to prevent exempt organizations that are general partners of a partnership from designating that partnership *as a QPI*. Accordingly, as currently proposed, this should not prevent an exempt organization that is the general partner of a partnership from treating that qualifying partnership *as a holding company partnership interest*.

[68] *See* section 731. Exceptions could apply if the lower-tier partnership interest were treated as a marketable security, if the distribution related to payments to the exempt organization as a successor-in-interest to a deceased partner, or if the mixing bowl rules applied to a distribution.

[69] Prop. Treas. Reg. § 1.512(a)-6(e)(1).

[70] Preamble, at 23186.

test (the "***aggregation rule***").[71] The aggregation rule does not apply to the de minimis test or the control prong of the control test.[72]

i. Broaden the categories of related interests

We recommend that Treasury and the IRS extend the aggregation rule to partnership interests that are owned by related persons within the meaning of section 267(b)(9)[73] and to exempt organizations that are "controlled taxpayers" (within the meaning of section 482),[74] both of which invoke similar concepts of functional control.

Under the Notice, the aggregation rule required aggregating the interests of supporting organizations, controlled entities, and disqualified persons. Moreover, the aggregation rule applied when determining ownership for the de minimis test as well.[75] Under the Proposed Regulations, the aggregation rule only applies when looking at the 20% control test ownership threshold, and no longer applies to interests of disqualified persons generally. Given the breadth of the disqualified person definition and the number of partnership interests implicated by the de minimis rule, we agree with, and appreciate, the changes proposed by Treasury and IRS. However, we also foresee opportunities for exempt organizations (and particularly those under common control) to take advantage of the bright-line rules present in the QPI framework.

For instance, consider the following example:

> Example 5. EO-1 through EO-5 are each controlled by a 5-person board that is governed by majority vote. Three family members, A, B and C, sit on each board. Each of EO-1 through EO-5 owns

[71] Prop. Treas. Reg. § 1.512(a)-6(c)(4)(ii).

[72] *Id.* (aggregation rule applies "[w]hen determining an organization's percentage interest in a partnership for purposes of paragraph (c)(4)(i) of this section [the 20-percent ownership threshold under the control test]").

[73] Under section 267(b)(9), a person and an exempt organization are related if the organization is controlled directly or indirectly by such person or (if such person is an individual by members of the family of such individual). Regulations further provide that, for this purpose, "control" includes "any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable." Treas. Reg. § 1.267(b)-1(a)(3) (further noting that, for an individual, control possessed by individual's family is also relevant).

[74] A "controlled taxpayer" is defined as "any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers." Treas. Reg. § 1.482-1(i)(5). For this purpose, "control" includes "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose." Treas. Reg. § 1.482-1(i)(4) (further noting that "the reality of the control" and not "its form or the mode of its exercise" is decisive). Common control exists where the board members of exempt organizations are identical. *See* PLR 9145033, PLR 9145033, PLR 8813071, PLR 8612062. The IRS has also taken into account the overlap of officers and even members in determining if common control exists, and has concluded that common control is present with as little as 43% overlap of directors where officers of the exempt organizations overlapped. *See* PLR 200125092.

[75] The aggregation rule in the Notice required that the exempt organization also take into account the interests of a "disqualified person" (within the meaning of section 4958(f)). The Notice also required combining related interests only when "determining an exempt organization's percentage partnership interest"—under both the de minimis rule and the control test. Notice, § 6.02(2)(b).

> 19% of PSH A, and none of them controls PSH A within the meaning of Proposed Regulations section 1.512(a)-6(c)(4)(iii).

In this example, PSH A is a QPI for each of EO-1 through EO-5. A, B and C can, collectively, make decisions for each of the five exempt organizations. Had EO-1 owned 95% of PSH A, EO-1 would have been required to identify the NAICS two-digit codes for the trades or businesses operated by PSH A, and separately state the UBTI associated with those businesses. However, by splitting ownership of PSH A across five exempt organizations under common control, each exempt organization's investment in PSH A is treated as an investment activity that may be aggregated with their other investment income and expenses.

It would be inappropriate for related or commonly controlled entities to structure their ownership of partnership interests in the manner described above so as to avoid reporting trade or business activity under the appropriate NAICS two-digit codes. Aggregating the interests of entities that are related under section 267(b)(9) or are treated as "controlled taxpayers" under section 482 principles would mitigate this concern.[76]

We acknowledge that the aggregation we propose could require the aggregation of certain interests of disqualified persons; relative to the Notice, however, this additional diligence and compliance would be implicated in far fewer situations. For one, an exempt organization would not need to verify a board member's ownership percentage unless that board member and/or his or her family members controlled the exempt organization. In addition, although many individuals may sit on a charity board, no verification of board member ownership would be needed unless the controlling members of that board also happened to collectively control the board of a different charitable organization. As both of the foregoing situations are rare[77] and would raise legitimate concerns about the control and governance of the exempt organization (and, as discussed below, control over a partnership), we view the additional diligence and compliance burden to this limited subset of exempt organizations as reasonably tailored to avoid abuse.

ii. Extend the aggregation rule to other indicia of control

We believe it would be reasonable to apply the rules aggregating certain related party interests to (i) the control prong of the control test, and (ii) the determination of whether an exempt organization is treated as owning a general partner interest.

The aggregation rule, as set forth in the Proposed Regulations, does not require an exempt organization to combine its related interests to determine whether an exempt organization "controls" a partnership or holds a general partner interest in a partnership. The control rights held by related interests (including as a general partner) would be germane to the "facts and circumstances" of the control prong. However, under the de minimis test, control (except for control exercised as a general partner) is not relevant. Moreover, as noted below in

[76] We note that the IRS has previously used section 482 principles to determine when one exempt organization is commonly controlled with another. Treasury regulations section 1.507-3(a)(2)(ii) cross-references the "controlled taxpayer" context in Treasury regulations section 1.482-1(a)(3) to determine whether two private foundations are "effectively controlled . . . , directly or indirectly, by the same person or persons". *See also* Treas. Reg. § 1.482-1(a)(3) (noting circumstances when a "controlled taxpayer" may apply section 482); Treas. Reg. § 1.482-1(i)(4) (defining "controlled taxpayer").

[77] These are also situations in which the exempt organization knows or should know the underlying facts.

Part IV(F)(4)(i), because a partnership is only excluded from the QPI framework if the exempt organization "*is* a general partner",[78] even if related interests are general partner interests, that partnership may still be treated as a QPI under the de minimis rule.

A controlled entity is generally a 50%-owned subsidiary of an exempt organization. An exempt organization is closely intertwined with its supporting organization.[79] The actual or functional control exercised by an exempt organization over the controlled entity or the supporting organization, and the common control exercised over two or more exempt organizations (if, as we recommend in Part IV(F)(2)(i) above, the scope of related interests is expanded in the final regulations), all justify treating control (including control as a general partner) exercised by one of these related interests as control of the exempt organization.[80]

iii. Exempt organizations should be required to segregate income derived by QPIs in respect of certain lower-tier partnerships

We recommend that, in certain abusive situations, exempt organizations be required to look through any partnerships that otherwise qualify as QPIs and segregate and report income attributable to certain lower-tier partnerships by the NAICS two-digit codes relating to the trades or businesses conducted by those lower-tier partnerships (the "***segregation rule***"). We believe the segregation rule, if adopted, should also require combining related interests (as defined in the final regulations), and should apply for purposes of the ownership threshold and control requirements (including whether that control is exercised as a general partner or managing member).

Under the Proposed Regulations, once an exempt organization has identified an upper-tier partnership as a QPI, no further inquiry is required with respect to the ownership and control of any lower-tier partnerships.[81] In tiered partnership structures, as described in the examples below, the result is that certain income attributable to certain lower-tier partnership interests that would not be QPIs if held directly can be "cleansed" and treated as income from investment activities:

> Example 6. An exempt organization directly owns 19% of PSH A and 19% of PSH B. PSH A also owns 81% of PSH B (such that the exempt organization indirectly owns 15.39% of PSH B through PSH A). The exempt organization does not control PSH A or PSH B. PSH B conducts three separate business activities that would be

[78] Prop. Treas. Reg. § 1.512(a)-6(c)(8)(ii) (emphasis added).

[79] A supporting organization is (i) "operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of" certain exempt organizations, and (ii) "operated, supervised or controlled by", or in connection with, those exempt organizations. Section 509(a)(3).

[80] To the extent our recommendation in Part IV(F)(2)(i) (relating to broadening the categories of related interests for purposes of the aggregation rule) is adopted, we would support those interests being aggregated for control purposes as well.

[81] The aggregation rule, as currently proposed, only applies to determine whether a directly held partnership meets the ownership threshold under the control test.

> reported under three separate NAICS two-digit codes if the exempt organization had conducted those activities directly.

The exempt organization's ownership of each of PSH A and PSH B satisfies the control test. The look-through rule and the aggregation rule do not apply. Nothing else in the Proposed Regulations require the exempt organization to combine its ownership of the directly and indirectly held ownership interests of PSH B. As a result, the exempt organization is effectively permitted to treat 34.39% of the income and expenses derived from PSH B as derived from investment activities.

Further, as the number of tiers of lower-tier partnerships increases, the aggregate income derived from a "bad" lower-tier partnership also increases. To illustrate, assume in Example 6 above that PSH B owns 81% of PSH C, and the exempt organization owns the remaining 19% of PSH C directly. The exempt organization's direct 19% interest in PSH C is a QPI under the control test. As a result, the exempt organization is able to treat 46.8559% of the income from PSH C as income from investment activities (i.e., 19% directly, 15.39% indirectly through PSH B, which is also a QPI, and 12.4659% indirectly through PSH A, which is also a QPI). Indeed, in theory, this number could approach 100%, although due to the expense associated with organizing multiple tiers of partnerships, exempt organizations are unlikely to find this structure to be cost-effective.

Another example also demonstrates how an exempt organization that controls a lower-tier partnership can also treat a significant portion of the income from that lower-tier partnership as part of its investment activities:

> <u>Example 7</u>. Exempt organization owns 19% of PSH A and a 1% general partnership interest in PSH B. PSH A owns 99% of PSH B.

Under these facts, PSH B is no longer eligible to be treated as a QPI. However, the exempt organization can still treat PSH A as a QPI as long as the control prong is satisfied. We would not expect the exempt organization's general partnership interest in lower-tier PSH B to affect whether the exempt organization is treated as controlling upper-tier PSH A. If the exempt organization does not control PSH A, then all of its income from PSH A (including that derived from PSH B, in which the exempt organization *is* the general partner) is treated as part of its investment activities.

As this example illustrates, even if an exempt organization is the general partner of a partnership (and is therefore generally unable to treat UBTI from the partnership as investment-related), it may remove the non-investment taint from nearly 20% of the partnership's income simply by holding a portion of that same partnership indirectly through a QPI. Moreover, as in the first example, adding additional tiers of QPIs can increase the percentage of income cleansed by the structure.

Neither of the results described above seems justifiable as a policy matter. If the Proposed Regulations are not changed, we expect that sophisticated exempt organizations will deploy these structures to maximize the treatment of trade or business activities conducted in partnership form as part of their investment activities, especially if those partnerships are highly profitable.

Accordingly, as noted above, we believe that the final regulations should provide that, if an exempt organization knows or has reason to know that a partnership that is a QPI owns an interest in a lower-tier partnership in which the exempt organization or a related entity also holds an interest, the determination of whether the interest in that lower tier entity owned through the QPI is included in the single investment activity business should be made by taking into account all of the interests owned by the exempt organization (and certain related parties). Thus, if the exempt organization (or a related party) is the general partner of the lower tier entity, the exempt organization's interest through the QPI is not an investment activity. The result is the same if the exempt organization, together with related parties, owns, directly or indirectly, more than 20% of the lower tier entity. In either case the exempt organization should be required to segregate the income attributable to that lower-tier partnership interest and report that income based on the NAICS codes relating to the lower-tier partnership's trades or businesses.[82] The remaining income allocable from that upper-tier partnership could continue to be aggregated with the exempt organization's other investment activities.

We recognize that, compared to the rule we propose, the Proposed Regulations have the advantage of simplicity—they identify QPIs using simple, largely bright-line tests that are highly administrable for both taxpayers and the IRS. Accordingly, a minority of our Executive Committee would follow the approach of the Proposed Regulations that any investment held by a QPI will be included in the combined investment trade or business. The majority however believes that the more traditional approach of looking through partnerships should be used to determine both the amount of the exempt organization's ownership as well as whether it controls the lower tier partnership. In almost all situations, this is information that the exempt organization will know (or should know) and therefore requiring this look through approach is not unduly burdensome.

A possible compromise would be to permit exempt organizations to treat as a QPI an investment in a partnership which satisfies the de minimis test (but not the control test) regardless of the amount of the interest in the lower tier partnership owned by the exempt organization. In that case, the amount of income or loss included in the combined investment activity would represent a small portion of the exempt organization's income from that activity. Even under this approach, however, there should be no exception and the exempt organization should still be required to segregate the income associated with any lower-tier partnership in which it (or a related entity) is or controls a general partner. As a practical matter, a partnership's general partner, including the exempt organization, will know who is invested into that partnership; to permit aggregation in this context would invite structuring around these rules.

iv. Anti-abuse rule

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[82] In the alternative, the government might consider preventing the partnership that would have otherwise qualified as a QPI from being designated as a QPI. This would certainly be simpler to apply, but would unduly penalize taxpayers, especially if the upper-tier partnership was identified on the basis of the de minimis rule. For example, if an exempt organization directly owns 2% of an upper-tier partnership, but also directly owns 45% of a lower-tier partnership that is 55%-owned by the upper-tier partnership, the exempt organization would need to separately identify all of the NAICS codes attributable to the trades or businesses conducted by that upper-tier partnership, despite having just a 2% interest in the upper-tier partnership (and a 1.1% interest in the offending lower-tier partnership through the upper-tier partnership).

As a general matter, we believe that it is beneficial to taxpayers for regulations to be drafted in a way that is clear and specific. Although we believe the above recommendations would achieve that goal, we understand that some of the recommendations set forth above would complicate much of the taxpayer favorable and fairly administrable rules that Treasury and the IRS have proposed. As an alternative to one or more of the recommendations suggested in this Part IV(F)(2), we would support the creation of a more general anti-abuse rule, perhaps one that would allow the IRS to conclude that a partnership interest is not a QPI if the facts and circumstances indicate that a principal purpose for a particular structure is to allow an exempt organization to avoid the de minimis or control tests.

3. Control test

As discussed above, under the control test, an exempt organization does not control a partnership if the exempt organization (i) owns no more than 20% of the capital interests of the partnership, and (ii) does not "control" the partnership (within the meaning of Proposed Regulations section 1.512(a)-6(c)(4)(iii)). We support the control test as a means to identify QPIs, but recommend that the IRS expand the ownership threshold to apply to profits interests as well. We also respond to the request for comments on the control prong of the control test.

i. 20% Ownership Threshold

We recommend that Treasury and the IRS provide that the 20% ownership threshold of the control test is satisfied if an exempt organization owns no more than 20% of both the capital *and profits* interests of a partnership. As noted above, Treasury and the IRS have described the 20% capital interest ownership threshold as a proxy for activities that may be part of an exempt organization's investment activities.[83] Moreover, the Preamble indicated that "the proposed regulations continue to consider only an exempt organization's capital interest in a partnership for purposes of the control test" because "an exempt organization's percentage profits interest may change throughout the year."[84] Yet, this concern is equally true of capital interests. Furthermore, taking into consideration the exempt organization's average profits ownership interest (or if our recommendation in Part IV(G)(1) is adopted, its highest profits ownership interest) would be more informative of whether the activities are investment-like than to ignore profits interests entirely. The approach to measuring ownership under the control test also differs from the method of measuring ownership under the de minimis test (including for purposes of the existing look-through rule); the de minimis threshold is determined by reference to an exempt organization's capital and profits interest in a partnership.

An interest in partnership capital is not necessarily correlated with an interest in partnership profits, particularly in operating joint ventures or when a partnership has issued preferred equity interests. Indeed, under the Proposed Regulations, a partnership in which an exempt organization owns a 10% capital interest and 90% profits interests could qualify as a QPI, but not vice versa. This could allow preferred equity investments, which might require allocating 100% of partnership profits to an exempt organization until a multiple of the exempt

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[83] Preamble, at 23181 (20% threshold is "a proxy to identify partnership interests in which the exempt organization does not significantly participate in any partnership trade or business and therefore may appropriately be considered an investment activity for purposes of section 512(a)(6)"). As noted in Part IV(F)(2), we do, however, believe that the ownership threshold should be determined by reference to direct and indirect control.

[84] Preamble, at 23181.

organization's contribution had been repaid, to be treated as a QPI. Distinguishing between capital interests and profits interests on this basis will create opportunities for sophisticated taxpayers to structure their ownership interests in partnerships so as to capture a meaningful portion of partnership economics, while satisfying the letter of the control test.

ii. Control Prong of the Control Test

We endorse the general facts and circumstances test for purposes of determining whether an exempt organization controls a partnership (within the meaning of Proposed Regulations section 1.512(a)-6(c)(4)(iii)). However, consistent with a facts and circumstances test and contrary to the approach in the Proposed Regulations, we believe the final regulations should clarify that none of the enumerated control rights is per se determinative of control.

Under Proposed Regulations section 1.512(a)-6(c)(4)(iii), whether an exempt organization controls a partnership is based on all facts and circumstances, including the partnership agreement.[85] However, the same provision in the Proposed Regulations goes on to say that, notwithstanding any facts or circumstances to the contrary, "an organization *controls a partnership if*" the exempt organization has one of four enumerated control rights.[86] Although we agree that each of the four enumerated control rights can be indicative of control, we believe that the broad language describing these rights would also cause many exempt organizations that cannot exercise any meaningful control over a partnership to be treated as controlling those partnerships.

For example, under the first control right, as noted in the discussion below, a negative consent right over the decision to change the legal form of the business entity from a partnership to a corporation could mean that an exempt organization "by itself, . . . may prevent the partnership from performing, any act that significantly affects the operations of the partnership". Under the second control right, an individual who manages an investment fund and is one member of a thirty-five person board of the exempt organization that votes by majority might cause that exempt organization to be treated as controlling the investment fund on the basis that the director has "rights to participate in the management of the partnership". Under the third control right, the fact that an employee works part-time for both the exempt organization and the partnership in unrelated back-office roles would mean that that employee of the organization can "conduct the partnership's business". Finally, if an exempt organization that had contributed certain intellectual property rights to a partnership had the power to remove employees who were revealed to have ties to its competitors, this might be viewed as a "power to . . . remove any of the partnership's . . . employees" in a manner indicative of control, rather than a reasonable limitation to protect trade secrets.[87]

Instead, we believe that the better approach would be to treat the presence of any one of the four enumerated control rights as creating a presumption of control. In turn, exempt

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[85] *See also* Preamble, 23181-82. In the Notice, this prong of the control test looked at an exempt organization's "control *or influence*" over a partnership. Notice, § 6.03.

[86] *See also* Preamble, 23181 ("The proposed regulations also list certain specific circumstances that evidence control, focusing on four discrete rights or powers."). This approach is similar to the one in the Notice, which enumerated certain rights as those that would mean an organization "has control or influence". Notice, § 6.03.

[87] *See* Prop. Treas. Reg. § 1.512(a)-6(c)(4)(iii).

organizations should have the opportunity to establish, by clear and convincing evidence, that, notwithstanding the presence of one or more control rights, the facts and circumstances as a whole demonstrate that the exempt organization does not control that partnership.[88] This approach balances the government's understandable desire to avoid treating controlled partnership interests as investment activities with the concern that the broadly drafted enumerated control rights will cause many partnerships to fall outside the QPI regime.

We also recommend that final regulations adopt two additional refinements to the control prong to further the administrability of the facts and circumstances test. First, the control rights in Proposed Regulations section 1.512(a)-6(c)(4)(iii)(A) should not apply to non-ordinary course actions. In an analogous situation, Treasury and the IRS have previously indicated that consent rights over extraordinary events may not be indicative of a right to "participate in the management and conduct of a partnership's business".[89]

Second, and relatedly, we recommend that the regulations include a list of rights that generally are not indicative of control. These are situations where an exempt organization's vote or right could be construed as an ability for the exempt organization, *by itself*, to cause a partnership to perform (or not perform) an act that could significantly affect the operations of that partnership. These votes or rights could, therefore, be viewed as evidence of control under the Proposed Regulations, but are not, in substance, truly indicative of control and after arise in contexts indicative of the absence of control. Specifically, we believe that the following minority rights should be included on this list: (i) consent rights over amendments that could disproportionately and adversely affect that investor; (ii) voting rights in respect of decisions that require unanimous consent of the partners; (iii) minority consent rights over certain non-ordinary course decisions that could affect the partnership (including rights with respect to sales of substantially all of the assets, a change in the type of business, restructuring, and resolving tax proceedings); (iv) tag-along rights, drag-along rights, rights of first refusal, rights of first offer, and the right not to participate in certain investments of a partnership; (v) having a seat on an advisory board in which decisions or recommendations require a majority vote or a

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[88] For example, if an investment professional with economic interests in both the manager and general partner of a commingled investment fund is a board member of an exempt organization and grants that organization a 3% limited partnership interest in the fund, we believe that those facts should establish a presumption of control under the control rights. However, the exempt organization should be permitted to rebut that presumption if, for example, that investment professional did not serve on the investment committee of, or otherwise had influence over the investment decisions made by, the exempt organization, the person is one of a thirty-five person board that votes by majority, and no other facts are indicative of control.

The IRS has relied on the clear and convincing evidence standard in the past. For example, under Proposed Regulations section 1.707-2(c)(1), taxpayers are permitted to rebut the presumption that a transaction is a disguised payment for services on the basis that the arrangement lacks significant entrepreneurial risk with clear and convincing evidence that demonstrate the presence of such a risk. In addition, taxpayers can challenge presumptions established under the conduit financing regulations with clear and convincing evidence to the contrary. *See* Treas. Reg. § 1.881-3(c)(2) (addressing whether an intermediate entity would have participated in financing arrangement on substantially same terms but for financing transaction with financing entity).

[89] Prop. Treas. Reg. § 1.892-5(d)(5)(iii)(B) ("Rights to participate in the management and conduct of a partnership's business do not include consent rights in the case of extraordinary events such as admission or expulsion of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities, merger, or conversion.").

supermajority vote of less than 80% (i.e., a 20% exempt organization should not be able to, by itself, veto a decision); and (vi) having one or more seats on an advisory board where the board is only empowered to make recommendations.

These rights could all be construed as running afoul of the control requirement, as currently drafted, in various ways. The rights described in clauses (i)-(iii) are consent rights, and, accordingly, for votes that require unanimous consent or the consent of the affected partner, could be viewed as the exempt organization "by itself" causing the partnership to act (or refrain from acting). In addition, the rights described in clause (iv) are more commonly viewed as agreements as between the partners. Finally, although we believe that the situations in clause (v) and (vi) were intended to be addressed by the removal of the "influence" aspect of the control test, given the prevalence of these arrangements, taxpayers would appreciate explicit guidance on this point.

However, the rights described above generally seek to provide a minority investor with some assurances that, despite being a non-controlling member of a partnership, the expectations associated with having made an investment (including the associated tax consequences) will not materially change without their consent. Minority investors (whether or not they are exempt organizations) bargain for these rights. Exempt organizations would be placed at a disadvantage relative to non-exempt organizations investing in these same partnerships if they were unable to do so. Moreover, if joint venturers are negotiating at arm's length, the interests of a controlling party should be adverse to those of an exempt organization acquiring a minority interest, and the risk of conferring effective control on an exempt organization via minority consent rights would be low.

Finally, we believe that the addition of such a list would allow all parties to apply the facts and circumstances test more consistently. The addition of the list, however, would not eliminate the ability of the IRS to use these factors in unusual circumstances to justify treating an exempt organization with one or more rights as effectively controlling a partnership.[90]

4. Other general comments

In addition to the comments noted above, we have the following general comments relating to the treatment of investments in partnerships.

i. General partnership interests and managing member interests should be treated consistently

We recommend that Treasury and the IRS expand Proposed Regulations section 1.512(a)-6(c)(8)(ii) to apply to managing member interests, in addition to general partner interests. Under the Proposed Regulations, "[a]ny partnership in which an organization is *a general partner* is not a QPI . . . regardless of the exempt organization's percentage interest" (the

[90] For example, one such circumstance would include where only the exempt organization, or a limited number of partners including the exempt organization, could prevent or require major actions.

"***general partner limitation***").[91] A restriction of this type appropriately excludes interests in partnerships that are effectively controlled by an exempt organization from qualifying as QPIs, and we recommend that Treasury and the IRS extend this restriction to the other substantively similar situations set forth below.

Parties are generally free to structure their partnerships as either limited partnerships or limited liability companies. A managing member of a limited liability company that is treated as a partnership for tax purposes plays an analogous role to that of a general partner. Accordingly, the general partner limitations should also apply if an exempt organization is a managing member. This change should not raise the state law concerns noted in the Preamble in respect of non-managing member interests.[92]

In addition, as an alternative to the recommendation in Part IV(F)(2)(i),[93] we recommend that the general partner limitation extend to an exempt organization not only if it "is" a general partner (or managing member), but also if it (or any related persons) *controls* the general partner (or managing member). For this purpose, "control" could have the meaning under the regulations as finalized or, in the alternative, be defined by reference to section 512(b)(13)(D) (generally, more than 50% ownership, after applying constructive ownership rules). Moreover, for this purpose, a "related person" could be any entity whose interests would be aggregated with that of the exempt organization under the aggregation rule, as finalized.

Thus, under the rule proposed above, if an exempt organization is not the general partner of a partnership, but owns 20% of the interests in the general partner, and its supporting organization owned 35% of the general partner interests, the exempt organization's interest in that partnership would not be a QPI. Absent this change, exempt organizations could easily form wholly owned controlled corporations that act as the general partner to effectively control a partnership while avoiding application of the control test. This could allow those exempt organizations to treat an up-to-20% owned partnership interest as part of its investment activities.

ii. Grace period for partnership interests that exceed ownership threshold for reasons beyond an exempt organization's control

In the Preamble, Treasury and the IRS acknowledged that an exempt organization could end up owning partnership interests in excess of the 2-percent de minimis or 20-percent control ownership thresholds, for reasons beyond its control.[94] Acknowledging that an exempt organization may be unaware of changes in its partnership interest until it receives a Schedule K-1, Treasury and the IRS requested comments as to whether exempt organizations should be

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[91] Prop. Treas. Reg. § 1.512(a)-6(c)(8)(ii). Given the reference to "*a* general partner" (rather than "*the* general partner"), we read this limitation to apply to exempt organizations that act as the general partner of a limited partnership, or as the (or one of multiple) general partners in a general partnership.

[92] Preamble, at 23180 (declining to adopt recommendation that all non-managing member limited liability company interests be treated as investment activities "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").

[93] In Part IV(F)(2)(i), we had recommended that interests of controlled entities, supporting organizations, and certain other related interests should be combined for purposes of evaluating the presence of certain control rights over a partnership (including control as a general partner).

[94] Preamble, at 23183.

permitted to own partnership interests in excess of those ownership thresholds "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."[95] This language suggests that an exemption would be provided for the year in which the increase occurs, as well as in future years.

We generally agree that exempt organizations should not be penalized if the increase occurs for reasons beyond their control, and would welcome guidance to this effect. However, granting an exempt organization an exemption from the ownership threshold for the current and all future years could lead to abuse. For example, an exempt organization could purchase a 19.9% interest in a partnership it does not control, with an understanding or expectation that one or more of the partners would be cashed out in the foreseeable future.

We believe a reasonable compromise would be to provide any exempt organization so affected with a grace period to reduce its increased percentage interest to meet the de minimis test or the control test, as applicable, if the increase resulted from the actions of other unrelated (or any other) partners.[96] As a practical matter, because an exempt organization may be unaware of these changes until after receiving its Schedule K-1, and because many investment partnerships, in particular, generally do not provide Schedules K-1 until four or six months after the end of the partnership tax year (if not later), we think a reasonable grace period should extend through the later of (i) the end of the taxable year immediately following the year of such increase, and (ii) 120 days after the date on which the partnership issued the Schedule K-1. Any exempt organization that chooses not to divest or take such other steps needed to again be treated as a QPI within the grace period would then always be able to begin reporting the trades or businesses of that partnership by their NAICS codes.

G. *Other Issues*

1. Modifications to Schedule K-1

We recommend that the final regulations require that pass-through entities maintain information and disclose on Schedule K-1 of Form 1060 and Form 1120-S the information necessary to enable exempt organizations to comply with section 512(a)(6). In particular, the pass-through entity should identify the proper NAICS two-digit code for each trade or business in which the entity is engaged and the exempt organization's percentage ownership in the partnerships held directly or indirectly. Moreover, upon the request of an exempt organization, the pass-through entity should make available to the exempt organization the information relating to the gross income and deductions from each trade or business conducted directly or indirectly by the pass-through entity.

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[95] *Id.*

[96] The concerns about knowing of an ownership change are present to a much lesser degree if the change in ownership interest results from the actions of a controlled entity or supporting entity (or, if the recommendation in Part IV(F)(2)(ii) is adopted, any other person whose interests would be aggregated with that of the exempt organization under the aggregation rule). In these cases, an exempt organization will know (or could know, by ensuring that proper monitoring or notification mechanisms are in place among related parties) of a pending change that would affect the exempt organization's ownership threshold.

Given the importance of identifying the proper NAICS two-digit code and an exempt organization's percentage ownership in a partnership to determine whether that partnership interest qualifies as a QPI, we believe that Schedule K-1 should also be modified to ensure that exempt organizations have the information necessary (i) to determine whether their partnership interests qualify as QPIs, (ii) to identify the NAICS two-digit code applicable to their unrelated trades or businesses conducted through non-QPI partnerships, and (iii) to report UBTI and associated expenses accordingly.

Accordingly, we recommend modifying Schedule K-1 in the following ways. First, as noted above in Part IV(A)(1), pass-through entities should be required to identify their separate trades or businesses by the NAICS two-digit codes on Schedule K-1, unless the pass-through entity is not aware that any of its direct or indirect owners is an exempt organization.[97] Having pass-through entities provide this information on Schedule K-1 would facilitate consistent reporting between the pass-through entity and its exempt partners for which the interest is not a QPI. In many cases, a non-controlling partner or shareholder may not have the right to request sufficient facts and information about a pass-through entity's various business activities to make an independent determination about the applicable NAICS two-digit codes. This is particularly true for investments in pre-existing joint ventures and commingled funds; in those cases, an exempt organization would not have known to negotiate for these rights.[98]

Second, we believe that the averaging method currently proposed—looking solely at ownership at the beginning and end of the partnership tax year (or ownership period, if shorter)—is easy to manipulate and misrepresents an exempt owner's ownership interest in the partnership.[99] For example, if the exempt organization owned 1% of the partnership on January 1, but owned 39% of the partnership for the next 364 days, the partnership interest could be treated as a QPI if the control prong of the control test were satisfied. If a test of administrative convenience is required, we believe a method less susceptible to abuse would be to identify the exempt organization's highest percentage interest in a taxable year.[100]

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[97] Based on the instructions to Schedule K-1 to Form 1065, a partner is required to inform the partnership of its exempt status.

[98] Even for new investments, although an exempt organization may seek to negotiate for specified rights, there is no guarantee that the exempt organization will be successful in doing so. In practice, partnerships have been reluctant to covenant to provide, for example, certifications to allow a transferee partner to eliminate or reduce a withholding obligation under section 1446(f) or, in the case of foreign partnerships, information that would allow a partner to make a QEF election in respect of an investment that could be treated as a passive foreign investment company to that investor. It does not seem appropriate to impose reporting requirements on an exempt organization with which the exempt organization is unable to comply for reasons outside of its control.

[99] *See* Prop. Treas. Reg. § 1.512(a)-6(c)(5)(ii).

[100] We note that although the weighted average based on number of days ("weighted average ownership interest") would most accurately represent of a percentage interest held within a given year, we recognize that this might be administratively too burdensome for partnerships to track and calculate for each partner, particularly for investment funds that have investors enter the fund on a delayed timing within one to two years from the initial closing. We believed that using the highest percentage ownership in a given year for this purpose would strike the balance between administrative ease and minimizing abuse. *Cf.* section 514(c)(7) (for purposes of computing the percentage of any gain or loss to be taken into account on a sale or other disposition of debt-financed property, using the highest

Third, we agree with Treasury and the IRS that exempt organizations may not rely on a Schedule K-1 that is silent on ownership percentage or reports them as "variable" for purposes of determining whether a partnership interest is a QPI.[101] However, rather than forcing taxpayers out of the QPI regime for something that is beyond their control, we recommend requiring partnerships to identify on Schedule K-1 ownership percentages of an exempt organization (and any pass-through entity through which an exempt organization owns any interest) that will be relevant for purposes of the QPI determination during the partnership's taxable year, unless the partnership is not aware that any of its direct or indirect partners is an exempt organization. Moreover, partnerships should be required to provide this information at a partner's request (whether or not that partner is an exempt organization). This information is necessary for the exempt organization to ascertain its percentage interest in the partnership. Exempt organizations with de minimis interests in a partnership are unlikely to have the negotiating leverage to ensure that partnerships provide this information. Moreover, exempt organizations that are trying to identify an indirectly held partnership interest as a QPI are unlikely to have privity with that partnership or an opportunity to request this information at all. Ensuring that this information is provided on Schedules K-1 will maximize the ability of all exempt organizations to identify and aggregate indirectly held QPIs and unrelated trades or businesses. Publicly traded partnerships should be exempted from this requirement.

Fourth, Schedule K-1 should also identify a partner's percentage interest in any indirectly-held partnerships, unless the partnership is not aware that any of its direct or indirect partners is an exempt organization. Again, this information should also be provided at a partner's request. Under the look-through rule, an exempt organization needs to know whether its interests in indirectly-held partnerships meet the de minimis ownership requirement.[102] As a result, the look-through rule is helpful only to the extent an exempt organization can readily identify its percentage ownership in such indirectly-held partnerships.

Finally, we recommend that upon the request of an exempt organization that is a direct or indirect owner, pass-through entities be required under the final regulations to identify the gross UBTI and gross deductions or expenses associated with *each* of its directly conducted trades or businesses and the gross UBTI and deductions or expenses attributable to each trade or business of indirectly-held partnerships or S corporations. With respect to partnerships, instructions to Schedule K-1 and section 6031(d) already require partnerships to provide information that would enable each partner to compute its distributive share of partnership income or loss from an unrelated trade or business in accordance with section 512(a)(1). Our proposed approach would merely require that, if specifically requested by the exempt organization, partnerships provide the same information but with respect to each trade or business conducted by the partnership (and its lower-tier partnerships) to allow exempt organizations to calculate UBTI in accordance with section 512(a)(6).

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amount of the acquisition indebtedness with respect to such property during the twelve-month period ending with the date of the sale or other disposition as the "average acquisition indebtedness").

[101] Prop. Treas. Reg. § 1.512(a)-6(c)(5).

[102] Prop. Treas. Reg. § 1.512(a)-6(c)(2)(ii).

Without this requirement, an exempt organization would need to negotiate with the pass-through entity to obtain the necessary information, and if it lacks the leverage to negotiate successfully, the exempt organization would only know the net UBTI across all of the pass-through entity's unrelated businesses. This would make it difficult for an exempt organization with an interest in a pass-through entity with multiple trades or businesses, some conducted through indirectly-held partnerships, to properly calculate UBTI where an interest is not treated as a QPI.

2. Transition Rule

As described above, if an exempt organization owns a transition partnership interest (i.e., a directly-held partnership interest acquired prior to August 21, 2018 that does not qualify as a QPI), the transition rule allows an exempt organization to treat that 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.[103] Some taxpayers and practitioners believed that the transition rule allows taxpayers with multiple transition partnership interests to aggregate all of those transition partnership interests into a single unrelated trade or business. We do not believe this was the intended effect of the transition rule. Therefore, we request clarification that, under the transition rule, each transition partnership interest is treated as a *unique* trade or business, and the income and deductions associated with that interest cannot be aggregated with that of other transition partnership interests (or any other trades or businesses).

3. Application of Section 512(a)(6) to the Public Support Test

The Proposed Regulations amend Treasury regulations sections 1.170A-9(f) and 1.509(a)-4 to allow organizations to aggregate net income and net losses from all of the unrelated business activities for purposes of calculating its public support. This change was intended to address the concern that an increase in unrelated business income due to the siloing required under section 512(a)(6) could adversely impact the public support calculation under section 509(a)(1) and (2), and cause public charities that have long satisfied the historic public support test to be treated as private foundations.[104]

We generally support this approach. Although we acknowledge that this means that certain exempt organizations would be required to prepare and maintain two sets of UBTI calculations on a going forward basis, we also note that any exempt organization that satisfies the

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[103] Under the Proposed Regulations, a transition interest 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. Prop. Treas. Reg. § 1.512(a)-6(c)(7)(i).

[104] Preamble, at 23191. There are two public support tests for public charities. Under one test, an exempt organization generally is treated as a public charity if (i) at least one-third of its total support comes from public governmental support and qualifying contributions from the general public and other public charities, or (ii) for an organization does not meet the requirements of (i), its combined public and governmental support is at least 10% of its total support and it can establish certain facts and circumstances demonstrating that the organization serves broad-based public interest. Treas. Reg. § 1.170A-9(f)(2), (3). Under a second test, an exempt organization generally is treated as a public charity if no more than one-third of its total support comes from gross investment income and UBTI. Section 509(a)(2).

public support test by siloing their trade or business activities to calculate its total UBTI necessarily will satisfy the public support test using the method advanced in the Proposed Regulations (i.e., calculating UBTI under the old approach without siloing trades or businesses). As also noted by Treasury and the IRS,[105] we do not believe that Congress intended to change the public support test when enacting section 512(a)(6). The approach in the Proposed Regulations eliminates the unintended consequences associated with changing the manner of calculating UBTI to taxpayers who have historically satisfied the public support test.

[105] Preamble, at 23191.