Section of Taxation

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June 21, 2018

David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on the regulatory implementation of new section 512(a)(6)

Dear Acting Commissioner Kautter:

Enclosed please find comments on the regulatory implementation of new section 512(a)(6) ("Comments"). They are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Tax Legislative Counsel, Department of the Treasury
Elinor Ramey, Attorney Advisor, Department of the Treasury
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON INTERNAL REVENUE CODE SECTION 512(a)(6) SPECIAL RULE FOR ORGANIZATIONS WITH MORE THAN ONE UNRELATED TRADE OR BUSINESS

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Megan E. Bell, Meghan R. Biss, Eve Borenstein, Dahlia B. Doumar, Laura Kalick, James Joseph, Jorge Lopez, John O'Connell, Alexander L. Reid, David A. Shevlin, Robert A. Wexler and Maura L. Whelan. These Comments were reviewed by Lisa L. Johnsen, Chair of the Exempt Organizations Committee. The Comments were further reviewed by Ellen Aprill of the Section's Committee on Government Submissions and by Melissa Wiley, Council Director for the Exempt Organizations Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 21, 2018

EXECUTIVE SUMMARY

These Comments respond to the request by the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") for comments on the regulatory implementation of section 512(a)(6) [1], which is described as a "near term priority" in the Priority Guidance Plan, Second Quarter Update, issued February 7, 2018 and on Part I, item 10 of the Priority Guidance Plan, Third Quarter Update, issued May 9, 2018.

Prior to the enactment of section 512(a)(6), as part of Public Law 115-97 (the "Act"),[2] exempt organizations were permitted to aggregate their losses and gains from all unrelated business taxable income ("UBTI"), and then report and pay taxes on the net UBTI, if any. New section 512(a)(6), which has colloquially been referred to as the "silo" rule, requires, beginning for tax years starting in 2018, that "[i]n the case of any organization with more than 1 unrelated trade or business—(A) unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to each such trade or business . . . ."

As discussed below, the definition of "each such trade or business" is the key issue requiring regulatory guidance in interpreting section 512(a)(6). The language of the statute draws the critical distinction between, on the one hand, UBTI from an "unrelated trade or business" and, on the other hand, all UBTI, regardless of whether the source is or is not an unrelated trade or business. The statute clearly states that *only* UBTI from an unrelated trade or business is subject to section 512(a)(6), and *only* in circumstances in which the organization actually operates more than one unrelated trade or business. The statute, therefore, does not apply to all UBTI, including UBTI from Passive Investments (defined below).

We recommend that regulations preserve and adhere to this important statutory distinction between UBTI from passive and active unrelated trade or business. This distinction is consistent with the underlying policy rationale for the unrelated business income tax, which is to curtail competition with actively carried on for-profit trades or businesses while at the same time preserving exempt passive income streams to support an organization's exempt activity.

In these Comments, we discuss situations in which identifying the boundaries of a trade or business is not readily apparent from the statutory language, and we offer recommendations for how to resolve these complex situations.

In these Comments, we recommend that:

1. Implementation of section 512(a)(6) be delayed until Treasury and the Service have an opportunity to issue proposed regulations, with an appropriate period for

[1] References to a "section" or "§" are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[2] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054.

public comment, to define what constitutes “each such trade or business.”

2. Treasury and the Service recognize a category of “Deemed UBTI” that is excluded from the purview of section 512(a)(6). By Deemed UBTI, we mean income and loss that is not derived from an exempt organization’s regularly carried on unrelated trade or business activity, but is included in UBTI only by virtue of a particular statutory rule or exception. Deemed UBTI might include, for example, section 512(a)(7) taxable fringe benefits, debt-financed income under section 514 that would not otherwise be treated as UBTI, payments from controlled corporations under section 512(b)(13), and income from an S Corporation under section 512(e) that is not controlled directly or indirectly by the exempt organization. We recommend that regulatory guidance exempt losses from Deemed UBTI from separate computation and permit losses from Deemed UBTI to offset any other UBTI.

3. UBTI or loss arising from investments over which the exempt organization does not exercise direct or indirect control (“Passive Investments”) also is excluded from the purview of section 512(a)(6). As with Deemed UBTI, we recommend that UBTI or loss arising from a Passive Investment not be treated as derived from an unrelated trade or business and that all losses from Passive Investments should be available to offset UBTI arising from any other source. While we understand that control can be defined in many ways, we believe it is appropriate to treat an exempt organization as controlling a limited liability company (“LLC”) or partnership where either (a) the exempt organization is either the manager or the general partner of the entity that is actually operating the trade or business or (b) where the exempt organization holds more than 50% of the profits or capital interests in the entity that is actually operating the trade or business (“Active Investment”). The 50% of profits or capital test is found in section 512(b)(13), and is also related to UBTI. Therefore, without statutory guidance, we believe that section 512(b)(13) provides a logical test for control in section 512(a)(6), another UBTI section.

4. With respect to UBTI or loss derived from trades or business operated directly by the exempt organization or Active Investments, an exempt organization apply the principal business codes from the 990-T to treat income and loss from the same type of activity as one trade or business. As an example, under this recommendation, an exempt organization would be able to treat multiple parking lots as one trade or business, multiple food service areas as one trade or business, and multiple golf courses as one trade or business.

5. Net operating losses (“NOLs”) be treated in a “first in first out” manner, consistent with the way in which NOLs customarily have been treated.

DISCUSSION

I. Overview

Historically, an organization carrying on two or more unrelated business activities calculated its UBTI as the aggregate of its gross income from the activities minus the aggregate allowable deductions.[3] In computing the deductions, organizations could account for expenses, depreciation, and similar items that would be deductible by a commercial enterprise so long as the deduction was directly connected with the unrelated trade or business.[4] An item is directly connected if it has a primary and proximate relationship to the carrying on of the trade or business.[5]

Under new section 512(a)(6), this calculation has changed. Now organizations with more than one unrelated trade or business are required to separately compute their UBTI for "each such trade or business."[6] This change results in the organization calculating the gross income minus the deductions, including any net operating losses, in separate "silos" for each trade or business it conducts.[7] The net income from each silo cannot equal less than $0. To determine its UBTI, the organization adds the amounts from these separate silos together.[8] Other than historic net operating losses, the gains or losses from one trade or business may not be used to calculate income outside of its specific silo.[9]

The language of section 13720 of the Act adding section 512(a)(6), section (A) reads as follows, with emphasis added:

> (6) SPECIAL RULE FOR ORGANIZATION WITH MORE THAN 1 UNRELATED TRADE OR BUSINESS. - In the case of any organization with **more than 1** unrelated trade or business -
>
> (A) unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to **each such trade or business** and without regard to subsection (b)(12),
>
> (B) the unrelated business taxable income of such organization shall be the sum of the unrelated business taxable income so computed with respect to each such trade or business, less a specific deduction under subsection (b)(12), and
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> (C) for purposes of subparagraph (B), unrelated business taxable income with respect to any such trade or business shall not be less than zero.

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[3] Reg. § 1.512(a)–1(a).
[4] Reg. § 1.512(a)–1(a).
[5] Reg. § 1.512(a)–1(a).
[6] I.R.C. § 512(a)(6).
[7] I.R.C. § 512(a)(6)(A).
[8] I.R.C. § 512(a)(6)(B); I.R.C. § 512(a)(6)(C).
[9] I.R.C. § 512(a)(6)(A).

By stating that it applies "[i]n the case of any organization **with** more than 1 unrelated trade or business," [*emphasis added*], section 512(a)(6) by its own language is looking to whether an exempt organization actually has more than one unrelated trade or business. Accordingly, we do not read the language in section 512(a)(6) as applying to income and losses that are attributed to the exempt organization solely by virtue of statutory provisions such as sections 512(a)(7), 512(b)(13), 512(e), or 514, or to investment income from trades or business that the exempt organization does not actually operate or control (directly or indirectly).

Our overall approach is based not only on the plain language of section 512(a)(6), but also on what little legislative history is available. The origins of section 512(a)(6) derive from the Service's Colleges and Universities Compliance Project Final Report (posted April 25, 2013, updated May 2, 2013) (the "Report") that focuses on situations in which exempt colleges and universities are operating some unrelated businesses at a loss primarily to offset income from their other unrelated trades or businesses. The Report focuses on a reporting of losses from activities that never generated a profit, such as fitness centers, recreation centers and sports camps, advertising, facility rentals, arenas, and golf courses. During the Colleges and Universities compliance project, the Service relied on the rules contained in section 183 and Regulation section 1.183-2(b)(1)-(9) to determine whether or not an activity was a trade or business under section 513.[10] In some instances, the Service determined that an activity was not a trade or business because it was an "activity not engaged in for profit" under section 183, when the activity had a history of producing losses.[11]

We see no reference in the Report, or in any of the very limited legislative history to section 512(a)(6), to suggest that Congress intended for silo rules found in section 512(a)(6) to apply to anything other than income and losses from an exempt organization's own loss producing trade or businesses.

II. Discussion of Specific Recommendations

A. Implementation of section 512(a)(6) should be delayed until Treasury and the Service have an opportunity to issue regulations, with an appropriate period for public comment, to define what constitutes "each such trade or business."

As a practical matter, in the absence of regulations, exempt organizations do not have sufficient information to know how to track their income and expenses in order to comply with the law. The new section 512(a)(6) represents a significant departure from the previous UBTI computation rules.

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[10] Internal Revenue Service, *Colleges and Universities Compliance Project: Final Report* at 12 (April 25, 2013), available at https://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_050213.pdf; Internal Revenue Service, *Form 14018 Compliance Questionnaire: Colleges and Universities* at 7 (September 2008), available at https://www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf. tege/sample_cucp_questionnaire.pdf.
[11] *Id.*

At a minimum, we urge the Service to not penalize exempt organizations in 2018 for failing to pay estimated taxes in connection with UBTI calculations under section 512(a)(6) made in good faith. Without guidance on how to calculate income under the new law, it would serve no legitimate purpose to apply penalties for failure to pay estimated taxes.

In addition, because there are at least three areas in which an exempt organization will not know, without regulatory guidance, how to report and pay unrelated business income tax ("UBIT"), it is reasonable and probably necessary to delay implementation.

First, exempt organizations do not yet have guidance on how to categorize income that is not derived from a trade or business activity of the organization, but rather that is deemed to be UBTI via a specific code section, such as sections 512(b)(13) (controlled subsidiary), 514 (debt-financed income), new section 512(a)(7) (fringe benefits), and 512(e) income from S corporations (unless the exempt organization controls them). Regulations might, following our recommendation, treat all such income and loss as not being subject to the section 512(a)(6) silo rules, but the regulations might also treat all such income as being contained in one distinct silo, or the regulations might require each source of Deemed UBTI to be in its own silo. The Code is silent.

Second, exempt organization do not yet have guidance on how to categorize income from investment partnerships or limited liability companies. An exempt organization that invests in investment partnerships or limited liability companies will receive one or more Schedule K-1s, *Partner's Share of Income, Deductions, Credits, etc.* These forms currently list only the total income and the total UBTI from the partnership. Without guidance, an exempt organization will not know whether to treat all of this income and loss outside of section 512(a)(6), as we recommend, to treat each K-1 as a separate trade or business, to aggregate the UBTI from all K-1s or to look through each K-1 to the underlying investments that the partnership has made to determine the trade or business state of each investment. The Code is silent.

Third, exempt organizations do not yet have guidance on how to treat income from substantially similar or the same activities. For example, if a university operates three parking lots is that one trade or business or three? The Code is silent.

As a practical matter, whatever rules are set forth in guidance, we understand that accounting software will need to be updated to accommodate the new rules and this may be a particular burden for small exempt organizations. Without regulations, it is unclear how the software should be formatted. Furthermore, exempt organizations would need to have kept appropriate records, and from them, make appropriate expense allocations, to make the correct estimated tax payments as the 2018 tax year unfolds.

An additional practical challenge for both exempt organizations and their return preparers and advisors is the lack of guidance on how to allocate shared expenses between separate trades or businesses. There is also little practical guidance as to how to fairly and reasonably allocate expenses between exempt-function operations and unrelated trade or business operations. The topic of acceptable allocation methodologies was the subject of a guidance project Treasury announced shortly after the release of the Advisory Committee to Tax-Exempt/Governmental Entities' 2014 Report on UBIT: the Priority Guidance Plan for 2014-2015 included (under "Exempt Organizations") item 9: *Guidance under §512 regarding methods of allocating expenses relating to dual use* (as did each of the ensuing three years' Priority Guidance Plans). Such guidance has yet to be issued.[12]

The requirement in section 512(a)(6) to calculate unrelated business taxable income amongst each unrelated trade or business expands the need for guidance to new realms – not only as to how taxpayers should allocate shared expenses between exempt-function activities and overall unrelated activities, but also how to further apportion expenses amongst unrelated activities when the same are characterized as separate unrelated trades or businesses. The need for clarification of what the Service will accept as appropriate expense allocation methods is key to implementation of section 512(a)(6)'s requirement that taxpayers determine for "each such trade or business" whether its revenue exceeded its associated expenses.

Given the significance of the change made by section 512(a)(6) as well as the number of fundamental (and in some case novel) issues raised by the new section that must be resolved, we are concerned that any guidance issued in 2018, particularly if that guidance is in the form of proposed regulations, will not become final and be sufficiently comprehensive to permit exempt organizations to confidently apply that statute in time to file their 2018 returns (let alone compute estimated tax payments during 2018. In addition, if the new rules require Office of Information and Regulatory Affairs review[13], there could be additional delay in the implementation of regulations.

There is recent precedent for delaying the implementation of a new law that may prove burdensome or administratively difficult in the absence of regulations. Consider the following:

- In January 2018, the Service, in response to public comments, issued Notice 2018-08 suspending indefinitely the effective date for withholding, under Pub. L. No. 115-97, new section 1446(f) with respect to dispositions of certain publicly traded partnerships until guidance is provided.[14]

- In 2013, Treasury delayed the effective date for the Patient Protection and Affordable Care Act (PPACA) mandatory employer and insurer reporting,

[12] See December 2, 2015 - AICPA Letter on Unrelated Business Income Expense Allocation Methodologies for Dual Use Facilities for recommendations, available at https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/2015-12-02-aicpa-comment-letter-eo-ubi-dual-use-facility-expense-allocation-methodologies.pdf.

[13] Memorandum of Agreement by and between the Department of the Treasury and the Office of Management and Budget with regard to Review of Tax Regulations under Executive Order 12866, dated April 11, 2018, available at https://home.treasury.gov/sites/default/files/2018-04/04-11%20Signed%20Treasury%20OIRA%20MOA.pdf.

[14] Notice 2018-08, 2018-7 I.R.B. 352.

under Pub. L. No. 111-148, by one year to allow for additional time to consider ways to simplify the new reporting requirements, as well as additional time to adapt health coverage and reporting systems.[15]

- In 2015 and 2016, the Service issued Notices 2015-57 and 2016-27, delaying three times the implementation date of the consistent basis reporting requirement, under Pub. L. 114-41, to provide transition relief and time to issue regulatory guidance for taxpayers and practitioners.[16]

For these reasons, we request that Treasury and the Service delay the implementation of section 512(a)(6) until final regulations are issued.

B. Deemed UBTI and loss should not be subject to section 512(a)(6).

We recommend that Treasury and the Service issue regulations confirming that UBTI and loss that is not derived from an unrelated trade or business that is actively carried on by an exempt organization (i) are not subject to the silo requirements of section 512(a)(6) and (ii) therefore should continue to be available to offset any UBTI or loss. We refer to such income as "Deemed UBTI" because despite not arising from a regularly carried on trade or business, the income is deemed to be UBTI under the Code.

1. Definition of Deemed UBTI

The UBTI-generating activities that exempt organizations engage in can be viewed as arising in two ways: (1) through an active unrelated trade or business, such as the sale of goods or performance of services, operated and controlled by the exempt organization; or (2) through an activity that generates income unconnected to any unrelated trade or business.

Based on the statutory language, Deemed UBTI is not covered by section 512(a)(6). Section 512(a)(6) applies only to organizations with more than one unrelated trade or business. Therefore, where there is zero or one unrelated trade or business, section 512(a)(6) does not apply by its terms. If an organization has a single unrelated trade or business, then under the language of section 512(a)(6), Deemed UBTI could be used to offset any losses arising from the unrelated trade or business and vice versa. Where there are two or more unrelated trades or businesses, the text of the statute requires the creation of a silo where UBTI is computed separately "with respect to each such unrelated trade or business."[17] Because Deemed UBTI does not arise from such (or any) unrelated trade or business, section 512(a)(6) does not direct that it be categorized in a silo of its own. As a result, any losses from Deemed UBTI would be available to offset income from other unrelated trades or businesses.

[15] Letter from Mark Mazur to Fred Upton, available at http://waysandmeans.house.gov/wp-content/uploads/2015/10/Treasury-Letter-20140408HL.pdf.
[16] Notices 2015-57, 2015-36 I.R.B. 294; Notice 2016-27, 2016-15 I.R.B. 1.
[17] I.R.C. § 512(a)(6)(A).

2. Types of Deemed UBTI

Deemed UBTI would include the following categories of income. They do not arise from an unrelated trade or business; rather, the income is considered UBTI because it arises as a result of being deemed such under various Code sections.

a. Taxable Fringe Benefits

New section 512(a)(7) provides that an exempt organization's UBTI will be increased by amounts paid or incurred, and for which a deduction under section 274 is not allowable, for any qualified transportation fringe (as defined in section 132(f)), any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), and any on-premises athletic facility (as defined in section 132(j)(4)(B)), except to the extent the amount paid or incurred is directly connected to an unrelated trade or business that is regularly carried on by the exempt organization.

The amount by which UBTI is to be increased by application of section 512(a)(7) to expenses associated with certain fringe benefits does not arise from a trade or business, and therefore is only Deemed UBTI. Thus, such payments are not covered by section 512(a)(6).

b. Unrelated Debt-Financed Income ("UDFI")

Under section 514, certain income and deductions that would otherwise be excluded from the scope of UBTI are nevertheless included in UBTI because the income is derived from debt-financed property. Debt-financed property, or property subject to "acquisition indebtedness," is debt (i) incurred by an organization in acquiring or improving such property; (ii) before the acquisition or improvement of such property if the indebtedness would not have been incurred but for such acquisition or improvement; or (iii) incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.[18]

The determination as to whether income is subject to UBIT pursuant to section 514 is whether the income was derived from debt-financed property rather than from the conduct of a trade or business. For this reason, UDFI is Deemed UBTI and not subject to section 512(a)(6).

c. Payments from Controlled Entities

If an organization (the "controlling organization") receives or accrues (directly or indirectly) a specified payment, defined as interest, annuities, royalties, or rent[19] from an entity which it controls (the "controlled entity"), the controlling organization must include such payment as an item of gross income derived from an unrelated trade or

[18] Reg. § 1.514(c)-1.
[19] I.R.C. § 512(b)(13)(C).

business to the extent such payment reduces the net unrelated income of the controlled entity (or increases the net unrelated loss of the controlled entity).[20] Control is defined, generally in section 512(b)(13)(D) as the ownership of more than 50% of the voting stock or holding or controlling more than 50% of the value of total shares of all other stock or interests. The purpose of this provision, as evidenced by the exclusion of dividends from the definition of specified payment, is to prevent an exempt organization from reducing or eliminating UBTI through the use of a controlled entity.[21] Because the UBTI arises only as a result of the receipt of certain types of income from a controlled entity rather than from conduct of an unrelated trade of business, the income is properly classified as Deemed UBTI. Thus, such payments are not covered by section 512(a)(6).

d. Ownership of S Corporation Stock

If an exempt organization[22] holds stock in an S corporation, the organization will recognize UBTI with respect to its ownership and disposition of stock in the S corporation regardless of whether the S corporation income is generated from passive or active interests.[23] Flow-through income from an S corporation and gain from a sale of stock in the S corporation is therefore Deemed UBTI because it does not arise from an unrelated trade or business, but rather because of the form in which the income-producing activity is held. Accordingly, income that is treated as UBTI solely because of section 512(e) should be categorized as Deemed UBTI for purposes of Section 512(a)(6). Where an exempt organization controls an S corporation, directly or indirectly, and where the S corporation generates active trade or business income, the S corporation should be treated in the same manner as a partnership, discussed in Section 3 below.

As described above, certain categories of income are subject to UBIT only because of statutory inclusions rather than from the conduct of an actively carried on unrelated trade or business. These Comments recommend, consistent with the statutory distinction, that such Deemed UBTI categories should not be placed in any one silo, but rather should be available to offset income and losses from any number of silos.

C. Passive investment income should not be subject to section 512(a)(6).

Section 512(a)(6) is intended to silo income and losses from an organization's multiple trades or businesses. Section 512(a)(6) specifically refers to an "organization with more than 1 trade or business." An organization that invests for its own account is not engaged in an active trade or business. In *Higgins v. Commissioner*, the U.S. Supreme Court, discussing a predecessor to section 162, held that an individual taxpayer's activities in managing his investments did not constitute a trade or business, "no matter how large the estate or how continuous or extended the work required may be . . . ".[24]

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[20] I.R.C. § 512(b)(13).
[21] Internal Revenue Service, *1980 EO CPE text*, at 1, available at https://www.irs.gov/pub/irs-tege/eotopicr80.pdf.
[22] I.R.C. § 1361(c)(6).
[23] I.R.C. § 512(e).
[24] 312 U.S. 212, 218 (1941).

Indeed, other Code sections treat income (and losses) from investments where the taxpayer does not materially participate as a passive activity and not income (or loss) from an active trade or business.[25] By analogy, any investment income and loss derived from a business over which an exempt organization does not exercise direct or indirect control would not be subject to section 512(a)(6).

The Service has acknowledged the "passive v. active" approach in determining what constitutes an active trade or business. In Revenue Ruling 69-574,[26] the Service endorses a passive test in determining whether activities constitute a trade or business for purposes of section 513. Further, Congress has specifically excluded such income items as dividends, interest, annuities, and royalties from the computation of unrelated business income under section 512(b). The Committee Report to the Revenue Act of 1950 makes it clear that Congress sought to tax the active business income of exempt organizations.[27] In Revenue Ruling 78-88, the Service acknowledges that the "legislative history of section 512(b)(5) of the Code indicates that Congress does not intend for ordinary or routine investment activities of a section 501(a) organization in connection with its securities portfolio to be treated as the conduct of a trade or business for purposes of section 513."[28]

Organizations that invest in multi-tiered limited liability companies and partnerships raise a number of issues. We recommend, however, that Treasury and the Service not require organizations to trace through and silo each instance of indirect UBTI, where the investment income is generated from passive activity. As a practical matter, it is currently not possible to obtain this information without extensive research and the cooperation of the managers or general partners of the entities at each level, which cooperation in our collective experience, often is not forthcoming.

Rather, we recommend Treasury and the Service make clear that section 512(a)(6) looks to an exempt organization's unrelated trade or business and, at least where the exempt organization does not directly or indirectly control the limited liability company or partnership, managing its own investment is not an active trade or business that would subject that activity to section 512(a)(6).

At the same time, we recognize that an exempt organization should be not able to circumvent section 512(a)(6) simply by creating a partnership or limited liability company, or multiple such entities, between it and the ultimate trade or business that it controls. In looking at control, it would still be necessary to distinguish passive income from active trade or business income. For example, an exempt organization that establishes a limited liability company to invest for its own account would still be generating passive investment income, and perhaps some Deemed UBTI, if for example the limited liability company had debt-financed income from trading on margin. To

[25] I.R.C. § 469(c).
[26] 1969-2 C.B. 130.
[27] Rev. Rul. 78-88, 1978-1 C.B. 163, for discussion of Congressional intent.
[28] *Id.*

classify debt-financed income as active trade or business income, it would be necessary to establish (1) that the exempt organization controls the underlying limited liability company or partnership; and (2) that the underlying limited liability company or partnership is operating an active trade or business. Where there are tiered entities, this analysis would require a look-through to the bottom tier entity that is actually operating the trade or business.

Absent statutory guidance, what test should Treasury and the Service apply in determining when an exempt organization controls a limited liability company or partnership? We have considered many alternatives, including the following:

- Section 1502 test for consolidated tax returns for for-profit companies;
- Section 414 tests for controlled groups;
- Section 4943 tests for "effective control;"
- Section 4942 test for common control;
- Section 512(b)(13) test for control of a subsidiary;
- Instructions under Schedule R of the Form 990.

We understand that there is no clear guidance on this point in the statute or the legislative history. In our view, the consolidated return and section 414 tests, while useful, are not directly on point, and in any case, their 80% control test would be too easy to circumvent. We note that in the UBIT arena, Congress initially had applied an 80% control test under Section 512(b)(13), but changed that test to a 50% control test in 1997. There is some evidence therefore that Congress recognizes a 50% test in the context of the UBIT.

While the 80% control tests are too easy to circumvent, the tests under sections 4942 and 4943 serve a different purpose and are too strict. These tests appear in the context of private foundations and are designed to be restrictive.

The section 512(b)(13) test provides that one exempt organization controls a limited liability company or partnership where it holds more than 50% of either the profits or capital interests. Schedule R to Form 990 adopts this test, but also provides that there is control, regardless of percentage ownership, where the exempt organization is the general partner or manager of a partnership or limited liability company. Although, there is no clear authority, we recommend adopting the Schedule R test as it combines an existing test used to determine UBTI (section 512(b)(13)) with a common sense test of what it really means to control a pass-through entity.

Accordingly, while income or losses from partnerships and limited liability companies typically would be considered passive investment income and would not be subject to section 512(a)(6), we believe that where an exempt organization is either the general partner or manager of a partnership or limited liability company, or where the exempt organization holds more than 50% of the profits or capital interests, then the exempt organization should be deemed to control the entity and the income or loss should be subject to section 512(a)(6). We recommend that this same rule could apply to income from an S corporation.

Consider the following examples:

A. An organization ("EO") invests in LLCs A, B, C and D, each of which operate active trades or businesses and allocates K-1 income to the EO. EO would not treat any of the income or loss from A, B, C, or D as being subject to section 512(a)(6) unless it controls A, B, C, or D by virtue of being a manager or by holding more than 50% of either the profits or capital interests. The EO is simply investing for its own account in businesses run by others.

B. An organization ("EO") invests in LLCs A, B, C and D, each of which operate different active trades or businesses and allocates K-1 income to the EO. EO manages B, and while it does not manage A, it owns more than 50% of the profits interest in A. EO would treat each of A and B as separate trades or business under section 512(a)(6), but any income or loss from C or D would not be subject to 512(a)(6).

C. An organization ("EO") invests in LLC A, which it controls. A, in turn, invests in LLCs B, C, and D, each of which operate active trades or businesses and allocates K-1 income to LLC A. A also invests in subchapter C corporations E, F, and G. A has no more than a 50% interest in B, C, and D, and does not manage B, C, or D. EO will receive a K-1 from A showing its UBTI from B, C, and D. EO will not show any dividends attributable to E, F or G as UBTI since these are subchapter C corporations. EO would not treat any of the income or loss from A, B, C, or D as being subject to 512(a)(6) because, even though EO controls LLC A, A is a passive investor in B, C, and D, and neither A nor EO controls B, C or D. Income or losses from A would thus be available to offset any other UBTI or losses.

D. Identical or similar activities should constitute one trade or business activity for purposes of section 512(a)(6).

Existing guidance on "unrelated trade or business" involves *whether* an activity is the sort that generates taxable income, but does not address how to determine separate trades or businesses for purposes of calculating an organization's income and expenses from those activities in the manner required by section 512(a)(6). In the UBTI context, the term "trade or business" has long been defined as having "the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."[29] Beyond the cross-reference to section 162, the term "trade or business" is not specifically defined in the Code or Treasury Regulations. Instead, guidance on the definition of a trade or business is found in cases interpreting section 162.[30]

[29] Reg. § 1.513-1(b).
[30] *See, e.g., Comm'r v. Groetzinger*, 480 U.S. 23 (1987); *Supra* Note 23, at 215.

The Service has also applied the "hobby loss" rules under section 183 in determining whether an activity is considered a trade or business for UBTI purposes. Section 183 defines an "activity not engaged in for profit" as an activity other than one for which deductions are available under section 162. During the Colleges and Universities Compliance Project, the Service relied on the rules contained in section 183 and Regulation section 1.183-2(b)(1)-(9) to determine whether or not an activity was a trade or business under section 513.[31] In some instances, the Service determined that an activity was not a trade or business because it was an "activity not engaged in for profit" under section 183, when the activity had a history of producing losses.[32]

Determining *whether* an activity constitutes a "trade or business" is necessarily a fact-based analysis. For example, in one revenue ruling the Service closely reviewed a university's activity in leasing a stadium. In determining that the activity constituted a trade or business, the Service considered numerous factors such as whether the university was responsible for providing utilities and services.[33] The Service determined that income was not excluded from the definition of unrelated business taxable income as rent from real property under section 512(b)(3). In a different revenue ruling, the Service finds that the rental of facilities *for a tennis* camp constituted a taxable unrelated trade or business when services were provided to the lessee.[34] The organization furnished dormitory rooms, linens, maid service, meals, and dining facilities, all of which caused the activity to generate unrelated business taxable income rather than rental income from real property under section 512(b)(3).[35] However, if the organization had instead provided no services to the lessee, the income from the activity would have been rental income from real property, and thus excluded from unrelated business taxable income under section 512(b)(3).[36]

Once a determination has been made that an activity is a "trade or business," however, none of the above guidance is particularly useful for distinguishing between activities for purposes of calculating the organization's unrelated business taxable income under the new law. Moreover, a fact-based analysis that requires an organization to separately account for each specific activity in a manner similar to that used for the determination of whether an activity is substantially related would be overly burdensome. If, for example, a single entity had income and expenses from both the rental of a stadium and the rental of tennis facilities for a summer camp, treating the income as two separate silos would result in a distorted view of the organization's income and expenses. This difficulty is especially true if the entity provided the same services for both activities, such as security, linens, and maintenance. In that instance, the entity could have expenditures that are shared across both activities and should be able to take those into

[31] *Supra* Note 9.
[32] *Id.*
[33] Rev. Rul. 80-298, 1980-2 C.B. 197.
[34] Rev. Rul. 76-402, 1976-2 C.B. 177.
[35] *Id.*
[36] Rev. Rul. 80-297, 1980-2 C.B. 196, situation 2, *amplifying* Rev. Rul. 76-402, 1976-2 C.B. 177.

account when calculating what its true income is from rental activities rather than attempting to allocate them across the two activities.[37]

We recommend that Treasury and the Service implement a common-sense definition that permits organizations to group their like-activities together rather than treating each activity conducted by an organization as a separate trade or business. Specifically, we recommend that Treasury and the Service rely upon the business classifications contained in the North American Industry Classification System (NAICS) to provide categories of various trades or businesses. This approach would allow organizations to appropriately group together their activities and account for their income and expenses in a manner that truly reflects how the organization is operating.

This type of approach is in line with various sections of the regulations that have permitted organizations to rely upon the NAICS codes.[38] It also is consistent with the current reporting mechanisms in place for exempt organizations. The Service uses NAICS codes in a variety of ways, including on its forms and instructions and in its statistical analysis of unrelated business activities. On forms and instructions, organizations currently use the NAICS codes on the Form 990-T and Form 990. Specifically, the instructions for those forms advise organizations to use the principal business activity codes from the NAICS when the organization is inputting amounts on its statement of revenue and expenses.[39] The Service also requires issuers of tax-exempt

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[37] Under the approach being proposed in these Comments, the organization would be able to calculate income and expenses from both of these rental activities in the same silo using NAICS code 531120, which is used for the rental of non-residential buildings and facilities. *See* https://www.census.gov/eos/www/napcs/finalized/web_531_ final_reformatted_edited_US021009.pdf.

[38] *See, e.g.*, Reg. § 1.199-3(m)(1)(i) (in determining whether an activity constitutes construction of real property in the United States, a taxpayer is considered to be engaged in the trade or business of construction if it is considered construction for purposes of the NAICS. Specifically, a trade or business that constitutes construction under the NAICS means construction under the two digit code of 23); Reg. § 1.936-11 (in determining whether a possessions corporation adds a substantial new line of business and thus loses its status as an existing credit claimant, the regulations provide a safe harbor that an activity is not a new line of business if it is within the same 6-digit NAICS code, or within the same 5-digit NAICS code if other facts and circumstances exist); Reg. 1.1031(a)-2 (in determining whether property has been exchanged for a different kind or class, product class is determined by referring to the NAICS definitions).

[39] Internal Revenue Service, *Form 990, Return of Organization Exempt from Income Tax*, Part VIII, lines 2a – 2e, 11a – 11c (2017); and Internal Revenue Service, *Instructions for Form 990*, Part VIII (2017). Statement of Revenue, Column (A) Tip (Jan. 18, 2018), https://www.irs.gov/pub/irs-pdf/i990.pdf ("If the organization enters an amount in column (A) for lines 2a through 2e or lines 11a through 11c, it must also enter a corresponding business activity code from Business Activity Codes. If none of the listed codes, or other 6-digit codes listed on the NAICS website at NAICS 2017 Census Chart, accurately describe the activity, enter '900099.' Use of these codes does not imply that the business activity is unrelated to the organization's exempt purpose."); Internal Revenue Service, *Form 990-T, Exempt Organization Business Income Tax Return*, block E (2017); Internal Revenue Service, *Instructions for Form 990-T* (2017), available at https://www.irs.gov/instructions/i990t#idm139825998964336 ("If engaged in more than one unrelated business activity, select up to two codes for the principal activities. List first the largest in terms of gross unrelated income, then the next largest. When classifying your unrelated activities for example, code income from advertising in publications as 541800, Advertising and related services, rather than selecting a code describing a printing or publishing activity.").

private activity bonds to use NAICS codes when describing projects financed by non-refunding proceeds on the Form 8038.[40] These codes are also used on the Form 1065.[41]

The Service also uses these business codes from the NAICS to report statistical information regarding the types of unrelated business activities in which exempt organizations engage. The Service's Statistics of Income office uses these codes to compute its data tables for unrelated business income tax returns by primary unrelated business activity or industrial grouping.[42] Researchers and others also use this data to report on the unrelated business activities of exempt organizations.

Under the structure we recommend, an organization that operates more than one of any similar activity for NAICS purposes, would be able to group those activities together in a single silo. For example, if an organization operates two gift shops, two cafeterias, and three parking lots, the organization would calculate its unrelated trade or business income in three separate silos – one for both of its gift shops (NAICS code 453220), one for both of its cafeterias (NAICS code 722514), and one for its three parking lots (NAICS code 812930). This approach is remarkably practical because these similar activities may have overlapping expenses, depreciation, or other similar items associated with them, such as staff or equipment. By grouping the activities together under their NAICS codes, the organization can accurately account for both its gains and losses from the activity.

If an organization instead is required to treat each activity separately, much as it does when determining if an activity constitutes an unrelated trade or business, it would be required to separately calculate unrelated business taxable income for seven different activities: each gift shop, each cafeteria, and each parking lot. This type of calculation would not accurately take into account the full picture of the organization's activities and its actual expenses in conducting those activities when the expenses are shared because the organization would have to determine how to appropriately allocate these shared expenditures, depreciation, or similar items across multiple silos. This type of allocation becomes even more complex when assets or facilities are also used in an exempt function

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[40] Internal Revenue Service, *Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues*, Part V, Line 32 (Rev. 4-2001); https://www.irs.gov/pub/irs-pdf/f8038.pdf.

[41] Internal Revenue Service, *Form 1065, U.S. Return of Partnership Income*, Items, A, B, and C (2017); Internal Revenue Service, *Instructions for Form 1065* (2017) ("[t]his list of Principal Business Activities and their associated codes is designed to classify an enterprise by the type of activity in which it is engaged to facilitate the administration of the Internal Revenue Code. These Principal Business Activity Codes are based on the North American Industry Classification System. Using the list of activities and codes below, determine from which activity the business derives the largest percentage of its 'total receipts.'").

[42] *See* I.R.M 1.13.1.2 (Dec. 3, 2015); *see also* Internal Revenue Service, *Statistics of Income, Table 5, Unrelated Business Income Tax Returns: Number of Returns, Gross Unrelated Business Income, Total Deductions, Unrelated Business Taxable Income (Less Deficit), Unrelated Business Taxable Income, and Total Tax, by Primary Unrelated Business Activity or Industrial Grouping*; Internal Revenue Service, Statistics of Income, *Table 8, Unrelated Business Income Tax Returns for 501(c)(3) Organizations: Number of Returns, Gross Unrelated Business Income (UBI), Total Deductions, Unrelated Business Taxable Income (Less Deficit), Unrelated Business Taxable Income, and Total Tax, by Primary Unrelated Business Activity or Industrial Grouping*. Both tables are available at https://www.irs.gov/statistics/soi-tax-stats-exempt-organizations-unrelated-business-income-ubi-tax-statistics.

and the organization is having to make a reasonable allocation between exempt and non-exempt functions.[43]

This type of approach is consistent with the approach contained in section 446, which allows organizations engaged in more than one trade or business to use a separate accounting method for each distinct trade or business, so long as the method used for that trade or business clearly reflects the income of that trade or business; the taxpayer maintains separable books and records for each trade or business; and the maintenance of different methods does not create or shift profits or losses between the trades or businesses.[44]

Finally, this approach is consistent with the legislative intent behind section 512(a)(6). In initially drafting the rule, the Ways and Means Committee made clear that the rationale behind this rule was inspired by a report issued by the Service in 2013 "detailing 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."[45] The Ways and Means Committee stated that the unrelated business income tax rules were being modified to "address these and similar loopholes."[46] In the Report, the Service stated that certain activities and operations such as fitness and recreation centers and sports camps, advertising, facility rentals, arenas, and golf courses resulted in the most frequent adjustments and disallowance of losses.[47] Similarly, the Service listed activities and operations such as facility rentals, conference centers, advertising, golf courses, and food service as being among the top loss generating activities.[48] Allowing an organization to group together their like-activities, even the ones reported to generate the most losses, would not alter the overall intent behind the legislation because (1) losses from these similar activities could not be used to offset gains in other silos; and (2) the new law provides that no individual silo may equal less than zero. Accordingly, even if an organization had significant losses in one silo, that amount would not act to reduce the gains in any other silo or the sum of the overall UBTI.

For these reasons, we recommend that Treasury and the Service adopt the approach of allowing organizations to combine like-activities together according to their NAICS codes for the purposes of separately calculating their unrelated trade or business taxable income.

E. Net operating loss ordering should follow the usual rules.

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[43] Reg. § 1.513-1(d)(4)(iii).
[44] Reg. § 1.446-1(d).
[45] Committee on Ways and Means, Majority Tax Staff Discussion Draft on the Tax Reform Act of 2014, WMCP 113-6 (Feb. 24, 2014) at 152.
https://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf
[46] *Id.*
[47] *Supra* Note 9, at 11-12.
[48] *Supra* Note 9, at Appendix C.

In addition to changing the rules surrounding UBTI, the Act also modified how organizations calculate their net operating losses ("NOLs"). Section 172 now provides that an organization is limited in its NOL deduction to 80% of taxable income for losses arising in years after December 17, 2017.[49] Additionally, organizations may now carryforward their post-December 2017 NOLs for an indefinite period, rather than having to limit them to a 20-year time frame.[50] Finally, organizations can no longer carryback their net operating losses.[51]

Guidance is needed on how these modifications to the rules for NOLs operate in conjunction with the rules under section 512(a)(6) and with the language from section 13702(b)(2) of the Act. Under that provision, organizations with NOLs incurred prior to 2018 do not have to calculate those historic NOLs within a silo. The section provides:

> (2) CARRYOVERS OF NET OPERATING LOSSES.—If any net operating loss arising in a taxable year beginning before January 1, 2018, is carried over to a taxable year beginning on or after such date—
>
> (A) subparagraph (A) of section 512(a)(6) of the Internal Revenue Code of 1986, as added by this Act, shall not apply to such net operating loss, and
>
> (B) the unrelated business taxable income of the organization, after the application of subparagraph (B) of such section, shall be reduced by the amount of such net operating loss.

Read together, all of these sections—section 512(a)(6), section 172, and section 13702(b)(2) of the Act appear to mean that NOLs incurred within a silo, post 2017, can be carried forward indefinitely to offset up to 80% of the income in the same silo. However, a post-2017 NOL from silo A cannot be used to offset income in silo B. Additionally, it appears that all pre-2018 NOLs can be carried forward (for up to 20 years) to offset total UBTI outside of any specific silo.

Even if this interpretation is accurate, a number of unanswered questions remain, including:

- Do the traditional NOL rules requiring a first in, first out approach apply? If so, then the NOLs incurred prior to 2018 would be used first to offset any net income, whether it is in a silo or not. The language contained in section 13702(b) makes the order of operations unclear. Taking into account the language in section 172, and the need for clarity for exempt organizations, exempt organizations would apply their historic NOLs first pursuant to section 172.

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49 I.R.C. § 172(a).
50 I.R.C. § 172(b)(2).
51 I.R.C. § 172(b)(1).

- What happens to post-2017 NOLs in a silo if the exempt organization is no longer operating that silo? Presumably, the NOLs would be lost, absent other authority. However, if the organization later resumed the activity that created the post-2017 NOL, could it recapture the NOL given its indefinite carryforward period? We believe that it should be able to do so.

- Will repeated NOLs in a specific silo continue to be an indicator for examination because the activity may not be a trade or business? Section 512(a)(6) was intended to prevent organizations from using loss generating activities to decrease overall UBTI, and the silo requirement largely alleviates the concern that an organization would operate an activity at a loss to offset other income. Accordingly, repeated losses in any given silo would not result in the collapse of that silo due to concerns that the organization is not engaged in a trade or business.

- When does an organization take into account its charitable deduction under section 512(b)(10) and how does that work with two new classes of NOLs – pre-2018 NOLs that are not in silos *and* post-2017 NOLs that are in silos? Under section 170(d)(2), an organization may take into account current year contributions and then carryover contributions in the order that they arose (with a limited carryover period of 5 taxable years). Additionally, section 170(d)(2)(B) provides a special rule when there are NOL carryovers to prevent organizations from having a double tax benefit. The Service has considered in other contexts the appropriate methods of calculating charitable contributions where there is not statutory guidance. In Chief Counsel Advice, the Service considered how to simultaneously calculate a charitable contribution deduction limit and the alternative minimum tax net operating loss deduction.[52] In addition to providing guidance on net operating losses, organizations also need guidance on the charitable deduction calculation.

CONCLUSION

Based on the discussion above, we respectfully request that Treasury and the Service delay implementation of the new section 512(a)(6) rules until final regulations have been issued that clearly address the definition of what constitutes "each such trade or business."

As we state above, we believe that:

1. Deemed UBTI is not income from any unrelated trade or business and should not be subject to section 512(a)(6). Accordingly, losses from Deemed UBTI may be used to offset other UBTI.

[52] CCA 201226021 (Jun. 29, 2012), available at https://www.irs.gov/pub/irs-wd/1226021.pdf.

2. Passive Investment income derived from limited liability companies or partnerships that an exempt organization does not control should not be subject to section 512(a)(6). Accordingly, losses from Passive Investment income may be used to offset other UBTI.

3. Substantially similar trade or business activities should be treated as a single trade or business for purposes of section 512(a)(6).

4. NOLs should be applied in the same order as set forth in section 172, with the oldest NOL being applied first.