June 23, 2020

Hon. Charles P. Rettig  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 512(a)(6)

Dear Commissioner Rettig:

Enclosed please find comments on the Proposed Regulations under section 512(a)(6) with respect to organizations with more than one unrelated trade or business. These comments 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. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Tom Callahan  
Chair, Section of Taxation

Enclosure  
cc:  Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury  
Roger Pillow, Senior Counsel, Office of Tax Policy, Department of the Treasury  
Bryan Rimmke, Attorney-Advisor, Department of the Treasury  
Hon. Michael Desmond, Chief Counsel, Internal Revenue Service  
William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service  
Janine Cook, Deputy Associate Chief Counsel, Employee Benefits, Exempt Organizations and Employment Taxes, Internal Revenue Service  
Stephen B. Tackney, Deputy Associate Chief Counsel, Employee Benefits, Exempt Organizations and Employment Taxes, Internal Revenue Service
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 (the “Section”) 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, Ossie Borosh, Nathan M. Doane, Dahlia B. Doumar, Joshua E. Gewolb, Norah Jones, James P. Joseph, Laura Kalick, Beverly Katz, Grace Kim, Jorge Lopez, Elizabeth M. Mills, Tanvi Mirani, J. Alexandra Mitchell, James O’Connell, Preston Quesenberry, Barbara Rosen, David A. Shevlin, Janice M. Smith, Carolyn O. Ward, Robert A. Wexler and Maura L. Whelan. The Comments were reviewed by Ellen P. Aprill of the Section’s Committee on Government Submissions and Eric Solomon, former Chair for the Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

Contacts: Carolyn O. Ward
(202) 508-4645
morey.ward@ropesgray.com

Robert A. Wexler
(415) 421-7555
wexler@adlercolvin.com

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I. EXECUTIVE SUMMARY

These Comments respond to Prop. Treas. Reg. § 1.512(a)(6) (“Proposed Regulations”) issued by the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) under section 512(a)(6) of the Code.1 These Comments supplement our comment letter dated June 21, 20182 (the “June 2018 Comments”) and our comment letter dated December 4, 20183 (the “December 2018 Comments”). We submitted the June 2018 comments in response to the Second Quarter Update of the Treasury and IRS Priority Guidance Plan4 and the December 2018 comments in response to Notice 2018-67.5

Prior to the enactment of section 512(a)(6) as part of the 2017 tax act6 (the “Act”), exempt organizations were permitted to aggregate their losses and gains from all unrelated business activities in order to report and pay taxes on the net unrelated business taxable income (“UBTI”), if any. New section 512(a)(6), which has colloquially been referred to as the “silos” 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 . . . 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.”

In these Comments, we respond to issues addressed in the Proposed Regulations. We summarize our recommendations and comments below; we note that the more detailed discussions of many of the recommendations include examples.

A. Separate Trades or Businesses

The Proposed Regulations set forth how organizations identify separate trades or businesses operated both directly by the organization and those operated by partnerships, including those that qualify as investments under a special rule for “qualified partnership interests.”7 We appreciate the manner in which the Proposed Regulations have balanced

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1 Unless otherwise indicated, all references to a “section” or “§” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”) and all “Treas. Reg. §” references are to the Treasury regulations promulgated under the Code, all as in effect (or in the case of proposed regulations, as proposed) as of the date these Comments.

2 ABA Tax Section, Comments on the regulatory implementation of new section 512(a)(6) (2018), available at: https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/062118comments.pdf.


5 2081-36 I.R.B. 409.


7 Unless otherwise indicated, references in these Comments to “partnerships” are also intended to apply to limited liability companies that are taxed as partnerships. References to limited partners are meant to include non-managing members of limited liability companies, as well.
the spirit and letter of the law with the need for a practical way in which to administer the rules.

In particular, we support the position in the proposed regulations that exempt organizations use the first two digits from codes found in the North American Industry Classification System ("NAICS") to identify their directly operated trades or businesses. We also endorse the principle that organizations select the NAICS code that most accurately describes the particular unrelated trade or business rather than the organization’s primary related activities. With respect to the use of the NAICS codes and the identification of separate trades or businesses, we recommend that the final Regulations also provide:

1. That organizations may aggregate some activities, even though those activities might be identified with different NAICS codes. As noted in the Preamble to the Proposed Regulations,8 the NAICS has 20 broad two-digit sector codes. Activities in separate sector codes overlap in ways we believe warrant aggregation. Additionally, in certain circumstances, the Proposed Regulations require an organization engaged in an unrelated business activity to separate the income into different categories based upon NAICS codes when one stream of income is wholly dependent upon another stream. We recommend that the final Regulations permit organizations to aggregate activities under the most appropriate single two-digit NAICS code in such instances. We also recommend that the final Regulations permit organizations to group certain integrated activities under a single NAICS code that most accurately describes the overall primary activity being conducted, even if the activities would otherwise fall across multiple NAICS codes, similar to the existing regulations under section 132

2. That organizations may modify their assignment to NAICS codes in later years in certain limited circumstances.

3. Confirmation that organizations that have previously adopted six-digit codes, permitted under Notice 2018-67, may now apply a two-digit code.

**B. Investment Income and Partnerships**

The Proposed Regulations address how organizations should treat income from investments.9 While we believe that nonprofits earning investment income are not engaged in a trade or business,10 we appreciate that the Proposed Regulations aim for clarity and administrative simplicity in the inherently complex process of identifying and separating out different groups of investment income. Rather than grouping investment income by the economic sector of the investment giving rise to the income, the Proposed Regulations recognize that organizations engage in similar activities with respect to various sources of investment income and, therefore, group certain investment income

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9 Prop. Treas. Reg. § 1.512(a)-6(c).
10 See June 2018 Comments supra note 2, 10–13; Higgins v. Commissioner, 312 U.S. 212 (1941).
together as a single activity. The Proposed Regulations provide that an organization can combine income and losses in one investment “bucket” or “silo” from what are defined in the Proposed Regulations as “qualifying partnership interests” (“QPI”), “qualifying S corporation interests” and “debt-financed property.” The definition of QPI is particularly important. In order for a partnership interest to qualify as a QPI and thus be treated as an investment, the Proposed Regulations provide that the interest must satisfy a de minimis test (“De Minimis Test”) or a control test (“Control Test”).

We recommend that the final Regulations provide:

1. A De Minimis Test of no more than 5%, rather than 2%, of profits and capital interests. We believe the higher threshold is appropriate because an organization that holds even a 5% interest (directly or indirectly) is unlikely to have the type of control or involvement in the day-to-day business of the partnership that is the focus of the De Minimis Test.

1. A Control Test of no more than 50%, rather than 20%, of the capital interest as well as more detail and examples as to what constitutes “control.” A 50% threshold aligns more closely with section 512(b)(13) and other exempt organization control provisions.

2. That both the De Minimis Test and the Control Test may be applied on a look-through basis to determine whether a lower-tier partnership might be a QPI.

3. Specific examples illustrating the application of the two QPI tests.

4. Guidance for situations in which an organization has not received a Schedule K-1 with the necessary information to complete its Form 990-T.

C. Income from S Corporations

The Proposed Regulations address the treatment of income from S corporations by providing that each S corporation will be treated as a separate trade or business. We recommend that the final Regulations instead provide that the organization assign a NAICS code to each S corporation based on the S corporation’s predominant activity.

D. Income from Controlled Organizations

The Proposed Regulations require that all taxable income from each controlled entity, as defined in section 512(b)(13), be in a separate silo. We recommend that the final Regulations either treat section 512(b)(13) UBTI as investment income that may be allocated to the investment income silo or permit all income from these entities to be placed in a single controlled entity silo.

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11 Prop. Treas. Reg. § 1.512(a)-6(c)(1), -6(c)(2).
12 Prop. Treas. Reg. § 1.512(a)-6(c)(3), -6(c)(4).
13 Prop. Treas. Reg. § 1.512(a)-6(e).
14 Prop. Treas. Reg. § 1.512(a)-6(d)(1).
E. Subpart F Income, GILTI, and Separate Silos for Foreign Insurance Income

The Proposed Regulations treat Subpart F income under section 951(a)(1)(A) and global intangible low-taxed income (“GILTI”) under section 951A(a) in the same manner as a dividend that is excluded from the unrelated business income tax (“UBIT”) under section 512(b)(1).15 The Proposed Regulations further provide that all Subpart F insurance income described in section 512(b)(17) be isolated into a separate silo.16 We welcome both of these provisions.

F. Net Operating Losses (“NOLs”)

The Proposed Regulations provide that pre-2018 NOLs are to be applied generally to UBTI before post 2018-NOLs are applied within silos.17 We recommend that the final Regulations provide guidance on how the temporary rules in the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) apply to the NOL ordering rules.18

We recommend that the final Regulations provide that organizations be permitted both the pre-2018 NOLs and the relief provided in the CARES Act in the manner that best serves the organization and minimizes UBTI. On June 8, 2020, the Service issued Frequently Asked Questions about the application of the CARES Act to NOLs. We recommend that the final Regulations include those FAQ responses.

G. Social Clubs, Voluntary Employees’ Beneficiary Associations (“VEBAs”), and Supplemental Unemployment Benefit Trusts (“SUBs”)

The Preamble to the Proposed Regulations states that for a social club (“Social Club”) whether an infrequent or non-recurring event is a separate activity or part of another activity depends on the facts and circumstances of the event and the particular club.19 Treasury and the Service requested comments regarding the particular facts and circumstances that should be considered in making the determination of whether such an activity should be considered as part of a larger trade or business or part of investment income. In our comments below we recommend some possible factors to be considered in final Regulations, such as likely recurrence and amount of gross income.

H. Public Support

Many section 501(c)(3) organizations must satisfy a complicated calculation regarding sources of funding to avoid classification as a private foundation. As the preamble to the Proposed Regulations explains, in general, this calculation involves the

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16 Prop. Treas. Reg. § 1.512(a)-6(d)(2).
17 Prop. Treas. Reg. § 1.512(a)-6(h)(2).
19 Preamble, supra note 8, at 23,189.
percentage of support from certain public sources over total support. Amounts of UBTI factor into the calculation of total support. We appreciate that the Proposed Regulations reconcile the new silo rules with existing public support regulations. We provide some additional comments, below, to highlight some of the difficulties that an exempt organization may have in implementing these rules, particularly under the section 509(a)(2) public support test, the test that applies to organizations with gross receipts related to their exempt purpose, such as symphonies, garden clubs, and many other membership organizations. We recommend that the final Regulations provide further guidance on applying the section 509(a)(2) test.

I. Transition Rules

We recommend that exempt organizations be permitted to apply the Proposed Regulations’ transition rules until the first day of the second taxable year beginning after the date the regulations are published in the Federal Register as final Regulations.

In addition, for partnership interests in particular, we recommend that exempt organizations be permitted to rely upon the special partnership transition rule until the exempt organization disposes of that partnership interest, such that it effectively serves as a grandfather rule.

II. OVERVIEW

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

Under new section 512(a)(6), this calculation has changed. Now organizations with more than one unrelated trade or business are required to compute their UBTI separately for “each such trade or business.” As a result of this change, an organization must calculate its gross income minus allowable deductions, including any NOLs, in separate “silos” for each trade or business it conducts. The net income from each silo cannot equal less than zero. To

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20 Preamble, supra note 8, at 23,191.
21 Preamble, supra note 8, at 23,192.
22 Prop. Treas. Reg. § 1.512(a)-6(c)(7).
23 Treas. Reg. § 1.512(a)-1(a).
24 Treas. Reg. § 1.512(a)-1(a).
25 Treas. Reg. § 1.512(a)-1(a).
26 IRC § 512(a)(6).
27 IRC § 512(a)(6)(A).
28 Preamble, supra note 8, at 23,174 (citing legislative history).
determine its UBTI, the organization adds the amounts from these separate silos together.\textsuperscript{29} Other than historic NOLs, the gains or losses from one trade or business may not be used to calculate income outside of its specific silo.\textsuperscript{30}

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

(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

(C) for purposes of subparagraph (B), unrelated business taxable income with respect to any such trade or business shall not be less than zero.

We offer comments on each of the issues identified in the Executive Summary.

III. RECOMMENDATIONS

A. Separate Trades or Businesses.

The Proposed Regulations provide that organizations generally identify their separate trades or businesses using two-digit NAICS codes.\textsuperscript{31} Once an organization selects its two-digit code for a particular trade or business, it may not modify that code unless the code was chosen in error and another code more accurately describes the activity under the Proposed Regulations. We appreciate the adoption of two-digit NAICS code standard\textsuperscript{32} because this choice, instead of the six-digit code advanced in Notice 2018-67, reduces the administrative burden for both the Service and organizations. We also agree that organizations should not be permitted to group their activities under a code that defines their tax-exempt activities (e.g., education, etc.), but rather should select the code that most accurately describes the overall unrelated trade or business.

We recommend that the final Regulations provide three additional sets of rules, as follows:

\textsuperscript{29} IRC § 512(a)(6)(B), (C).
\textsuperscript{30} IRC § 512(a)(6)(A).
\textsuperscript{31} Prop. Treas. Reg. § 1.512(a)-6(b).
\textsuperscript{32} In our June Comments, supra note 3, at 7, we recommended that the Service adopt a two-digit NAICS code safe harbor in line with Treas. Reg. § 1.132-4.
1. **Aggregation of Some Activities**

As noted in the preamble to the Proposed Regulations, the NAICS has 20 broad two-digit sector codes.\(^{33}\) However, activities in separate sector codes overlap in ways we believe warrant aggregation. Additionally, in certain circumstances, the Proposed Regulations require an organization engaged in an unrelated business activity to separate the income into different categories based upon NAICS codes when one stream of income is wholly dependent upon another stream. We recommend that the final Regulations permit organizations to aggregate activities under the most appropriate single two-digit NAICS code in such instances.

The NAICS system groups several of the sector codes together when describing the overall sector. These groupings include 31-33 (manufacturing), 44-45 (retail trade), and 48-49 (transportation and warehousing). Strict adherence to the two-digit number causes activities in those categories to fall under separate silos for purposes of calculating UBTI, even though NAICS classifies the sector together. This consequence occurs even if the activity is operated in the same space, using the same employees, and in some instances involves the same items. For example, an organization operating a gift shop selling clothing, electronics, and books would report those activities under two categories because the activities fall under NAICS codes 44 and 45—code 44 for clothing and electronics and code 45 for books. Similarly, an organization that sells clothing in store and online would report income under two separate categories—code 44 for clothing and code 45 for online shopping.

Separating these manufacturing, retail, and transportation/warehouse activities in this manner increases the burden on organizations. These organizations would have to account separately for activities that would otherwise be tracked together. As a result, these organizations might well need to keep a separate set of books for these activities, a practice that will burden them and might also make it more difficult for the Service to conduct audits. Thus, we recommend that the final Regulations permit organizations to aggregate the activities identified by NAICS codes 31-33 as one silo, codes 44-45 as one silo, and codes 48-49 as one silo. Thus, an organization selling clothing in store and online could report the income from both activities using either code 44 or 45.

We also recommend that the final Regulations permit organizations to group certain integrated activities under a single NAICS code, even if they would otherwise fall across multiple NAICS codes. In determining the appropriate NAICS code, organizations would look to the primary activity being performed and then categorize the intertwined activities under the NAICS code for the primary activity. As one common example, a university conference center may be engaged in integrated activities but may be required to segregate those activities based solely upon the two-digit NAICS codes if the fragmentation rule

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\(^{33}\) Preamble, *supra* note 8, at 23,174.
of Treas. Reg. § 1.513-1(b) were to apply. Leasing of the conference space would fall under the NAICS code for rentals (code 53). If, as part of the rental, the university provided refreshments or other catering services (as is common at conferences) and also provided security services, then the university may be required to report income under two additional categories—code 72 for the catering activity and code 56 for security—in addition to of the amount being reported for the rental income.

The same issue arises for many activities conducted by organizations. For example, under the Proposed Regulations, golf courses, concerts, and movies could all have activities that would be placed into separate categories. A golf course could have green fees, catering, and a pro shop that sells sports equipment and clothing. Although these activities all follow from the primary activity of running a golf course, an organization may need to classify the income into four separate categories for purposes of calculating UBTI—code 71 for the golf course, code 72 for the catering, code 45 for the sports equipment and code 44 for the clothing. Similarly, a museum showing movies at its theater during non-museum operating hours could have income from the movie theater (code 71) and income from the sale of food and beverages (code 72) for those attending the movie, if a principle similar to the fragmentation rule applies.

Instead of requiring organizations to classify income with such granularity, we recommend that the final Regulations provide flexibility to classify the income for integrated activities in a single category based upon the two-digit NAICS code that most accurately describes the overall primary activity being conducted. In the conference center example, the university would be able to treat all of the income in a single silo under the rental activity silo because the catering and security services are being provided as a service that is directly related to the primary rental activity. Similarly, the organization running the golf course would classify all of the income under code 71 for arts, entertainment, and recreation because the green fees, pro shop, and dining all derive from the primary golf course activity.

Both the regulations under section 132 and the NAICS recognize that some activities have overlaps that warrant aggregation. The regulations under section 132 permit aggregation of two-digit codes in determining separate lines of businesses in specific circumstances:

(i) If it is uncommon in the industry of the employer for any of the separate lines of business of the employer to be operated without the others, the separate lines of business are treated as one line of business.

(ii) If it is common for a substantial number of employees (other than those employees who work at the headquarters or main office of the employer) to perform substantial services for more than one line of business of the employer, so that
determination of which employees perform substantial services for which line or lines of business would be difficult, then the separate lines of business of the employer in which such employees perform substantial services are treated as one line of business. For example, assume that an employer operates a delicatessen with an attached service counter at which food is sold for consumption on the premises. Assume further that most but not all employees work both at the delicatessen and at the service counter. Under the aggregation rule of this paragraph (a)(3)(ii), the delicatessen and the service counter are treated as one line of business.

(iii) If the retail operations of an employer that are located on the same premises are in separate lines of business but would be considered to be within one line of business . . . if the merchandise offered for sale in such lines of business were offered for sale at a department store, then the operations are treated as one line of business. For example, assume that on the same premises an employer sells both women’s apparel and jewelry. Because, if sold together at a department store, the operations would be part of the same line of business, the operations are treated as one line of business.34

Similarly, the NAICS applies the codes on an “establishment” basis and looks to the primary activity of an establishment.35 Although the separation of lines of businesses or establishments is distinct from separating trades or businesses, we believe that the frameworks provided in section 132 and the NAICS are useful guides for permitting organizations to aggregate activities in some circumstances.

2. Permitted Change in NAICS Codes.

The Proposed Regulations permit an organization to change the two-digit code it has selected for classifying its trades or businesses only when there has been an unintentional error.36 However, the Proposed Regulations do not describe what constitutes an unintentional error. Additionally, the narrow proposed rule fails to recognize that an organization’s activities may shift so that the initial code no longer accurately describes the activity.

Thus, we recommend that the final Regulations provide that an organization may change its two-digit code if the nature of the activity has materially changed and another code more accurately describes the activity. We

34 Treas. Reg. § 1.132-4(a)(3).
36 Preamble, supra note 8, at 23,175.
also recommend that the final Regulations or the form instructions describe situations when it is appropriate for an organization to modify its two-digit code. For example, an organization might wish to modify its two-digit code if it had relied upon the advice of a CPA or attorney in selecting a two-digit code and a new advisor later determines that another code would have been more accurate. We recommend that the final Regulations clarify that an organization can change the NAICS code classification of an activity if either its tax preparer reasonably determines that a different NAICS code more accurately describes the activity than the code used by a prior return preparer or the nature of the activity has changed.


Under Notice 2018-67, the Service directed organizations to classify their activities using a six-digit NAICS codes. As a result, some organizations have already begun to separate and classify their activities using that detailed system. As noted in the Preamble for the Proposed Regulations, the broader two-digit codes permit organizations to group a greater number of activities together while still respecting Congressional intent behind section 512(a)(6). We recommend that the final Regulations confirm that organizations reporting under the six-digit system may reclassify their activities using the two-digit codes for future reporting, without requiring an “unintentional error” to change their NAICS codes.

B. Investment Income.

The Proposed Regulations provide that an organization’s “activities in the nature of investments” be grouped in one collective investment income silo. The Proposed Regulations limit this investment income silo to qualifying S corporation interests, income from debt-financed property described in section 514, and income from QPIs.

To constitute a QPI, a directly held interest in a partnership must meet either the De Minimis Test or the Control Test. An indirectly held partnership interest will be a QPI only if it meets the De Minimis Test on a look-through basis. The organization cannot be a general partner in the partnership.

Partnership income that does not qualify for the investment income silo is assigned a NAICS code and grouped with other activities that have the same NAICS code. While we support this overall treatment of investment income, we recommend that the final Regulations include some revisions, as described below.

37 See supra note 5.
38 Preamble, supra note 8, at 23,174.
39 Prop. Treas. Reg. § 1.512(a)-6(c)(1).
40 Prop. Treas. Reg. § 1.512(a)-6(c)(2)(i).
1. \textit{De Minimis Test}

Prop. Treas. Reg. § 1.512(a)-6(c)(3) provides that an organization’s directly held partnership interest meets the \textit{De Minimis} Test only if the interest is no more than 2\% of the profits interest and no more than 2\% of the capital interest of the partnership.\textsuperscript{42}

We continue to recommend, as we did in our December 18 Comments,\textsuperscript{43} that the final Regulations increase the \textit{de minimis} threshold to at least 5\% in order to reflect the realities of partnership investments. There is little or no difference as a practical matter between a 2\% interest and a 5\% or even a 10\% interest. In other areas of the tax law 5\% operates effectively as a \textit{de minimis} threshold. For example, Treas. Reg. § 1.162-28 allows taxpayers to treat time spent on lobbying activities as zero if less than 5\% of the person’s time is spent on lobbying activities. Similarly, Treas. Reg. § 1.199-1 allows a taxpayer to treat all of its gross receipts as domestic production gross receipts (“\textit{DPGR}”) if less than 5\% of the taxpayer’s total gross receipts are non-DPGR (after applicable exceptions). As a third example, under section 897(h)(4), stock in a publicly traded corporation is not a U.S. real property interest unless the holder holds more than 5\% of the stock. A 5\% \textit{de minimis} provision here would offer consistency with other \textit{de minimis} provisions.

2. \textit{Control Test}

The Proposed Regulations provide that an exempt organization’s directly held partnership interest will meet the Control Test if the exempt organization (i) directly holds no more than 20\% of the capital interest of the partnership (“\textit{Prong 1}”) and (ii) does not control the partnership (“\textit{Prong 2}”).\textsuperscript{44} An organization must combine its interests with those of its supporting organizations and controlled entities for purposes of determining whether the 20\% limit is met.\textsuperscript{45} Because obtaining information from Type III supporting organizations will be very difficult, we recommend that they not be included in this attribution rule.

We recommend, for largely practical reasons, that the final Regulations make changes to both prongs.

\textsuperscript{42} Prop. Treas. Reg. § 1.512(a)-6(c)(3). Significantly, the Proposed Regulations do not require an organization to combine its interests with those of any other person for purposes of determining compliance with the \textit{De Minimis} Test. \textit{See} Preamble, \textit{supra} note 8, at 23,132. We welcome and appreciate this change from Notice 2018-67 for the reasons noted in our prior comments. \textit{See} December 2018 Comments, \textit{supra} note 3, at 18–19.

\textsuperscript{43} \textit{See} December 2018 Comments, \textit{supra} note 3, at 16–17.

\textsuperscript{44} Prop. Treas. Reg. § 1.512(a)-6(c)(4).

\textsuperscript{45} Prop. Treas. Reg. § 1.512(a)-6(c)(4)(ii).
a. Prong 1

As in Notice 2018-67, Prong 1 focuses on an exempt organization’s capital interest in a partnership and sets the threshold at 20%. The threshold is intended to serve as a “proxy to identify partnership interests in which the exempt organization does not significantly participate in any partnership trade or business.” In our view, 20% is an inappropriately low threshold. It is very uncommon in our experience for an organization with a 20% or even 30% interest to have any level of control over the partnership. Prong 2, as discussed below, provides a sufficient mechanism to exclude those investments in which the exempt organization significantly participates or which it in fact controls. While we appreciate the need for a “bright line” test to identify the universe of interests that may qualify as a QPI under the Control Test, we believe such a line should be drawn consistently with the many other control tests throughout the Code, most notably those already applicable to the UBIT rules.

We continue to believe that the best test for whether an organization controls a partnership for a UBIT-related purpose is found in section 512(b)(13), which addresses precisely this issue. Section 512(b)(13) provides that control exists when an exempt organization owns more than 50% of the profits or capital interest in a partnership. Many areas of tax law, including those that apply to tax-exempt organizations in a number of different contexts, rely on this UBIT rule to define control. For example, recent guidance issued under sections 4960 and 4968, each of which was enacted at the same time as section 512(a)(6), has proposed a 50% threshold modeled off of the definition of control under section 512(b)(13). Section 4968, which imposes an annual excise tax of 1.4% on the net investment income of certain educational institutions, is particularly instructive. It generally attributes to the applicable educational institution the assets and net investment income of any related organization. A related organization is defined in section 4968(d)(2) as any organization that controls, or is controlled by, the institution, is under common control with the institution, or is a supported organization or supporting organization with respect to the institution. In proposing the 50% control threshold for purposes of sections 4960 and 4968, Treasury and the Service emphasized the administrative

46 See supra note 5.
47 Preamble, supra note 8, at 23,181.
48 See June 2018 Comments, supra note 2, at 12–13.
convenience of this approach, particularly because it reflects a standard that is found in other exempt organization control tests.\textsuperscript{50}

The excess benefit transaction rules under section 4958, for example, also define “control” by an applicable tax-exempt organization to include, among other things, ownership of more than 50% of the profits interest or capital interest in a partnership.\textsuperscript{51} The 50% control threshold also is consistent with the threshold set forth in the Form 990 instructions for reporting related organizations.\textsuperscript{52}

A greater than 50% ownership threshold establishes “control” in other contexts as well. The controlled group provisions in section 1563(a), for example, use a control threshold of either at least 80% or more than 50% depending on the circumstances. Additionally, section 267, which disallows or defers certain deductions in connection with transactions between related parties, identifies a variety of relationships, several of which are based upon control consisting of more than 50% ownership. Section 267 also adopts controlled group rules from section 1563, subject to modifications decreasing the 80% threshold to a more than 50% threshold. Section 707(b), the partnership equivalent of section 267(b), similarly relies upon the more than 50% ownership threshold. Specifically, section 707(b)(1)(A) disallows a deduction of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in the partnership. Many provisions throughout the Code have adopted the related party definitions under either or both of sections 267(b) and 707(b) and the more than 50% ownership tests thereunder.\textsuperscript{53}

In light of the foregoing, we continue to recommend that the “control” threshold used in Prong I be based on at least majority ownership (i.e., more than 50%).\textsuperscript{54} This recommended threshold, if

\textsuperscript{50} The Preamble to the Proposed 4968 Regulations states that its use of a more than 50% standard is based “on the definition of control under section 512(b)(13)(D) and the regulations thereunder” as well as generally aligning with “annual reporting requirements on Form 990.” \textsuperscript{84} Fed. Reg. 31,795, 31,801 (July 3, 2019). The Preamble to Proposed 4960 Regulations explains, “Use of a greater than 50 percent standard . . . aligns more closely with other exempt organization control tests.” \textsuperscript{85} Fed. Reg. 35,746, 35,748 (June 11, 2020).


\textsuperscript{52} \textit{See also} IRC § 6033(h)(1) (requiring that controlling organizations report on their respective returns any interest, annuities, royalties, or rents received from each controlled entity (within the meaning of section 512(b)(13))).

\textsuperscript{53} \textit{See e.g.}, IRC §§ 167(e)(5) (depreciation), 179(d)(2)(A) (election to expense certain depreciable business assets), § 336 (gain or loss recognized on property distributed in complete liquidation), 351(g)(3)(B) (transfers to controlled corporations), 355(d)(7)(A) (distribution of stock and securities of a controlled corporation), 382(n)(3)(B)(ii)(I) (limitation on net operating loss carryforwards and certain built-in losses following ownership change), 1031(f)(3) (like-kind exchanges).

\textsuperscript{54} \textit{See} June 2018 Comments, \textit{supra} note 2, at 12; December 2018 Comments, \textit{supra} note 3, at 17–18.
adopted, would align more closely with section 512(b)(13) and other exempt organization control tests described above, including, importantly, the definition of “related organization” for purposes of the annual reporting requirements on Form 990. With such a change, most exempt organizations would have one clear and relatively uniform threshold for determining “control” under a number of provisions applicable to them. This uniformity would allow organizations to administer section 512(a)(6) more efficiently, and, in turn, dedicate more resources to their tax-exempt purposes.

b. Prong 2

The Proposed Regulations provide that “all facts and circumstances” are relevant in determining whether an exempt organization has control over a partnership for purposes of Prong 2 of the Control Test.55 We consider a subjective component to be appropriate here and support its inclusion in final Regulations. We also support limiting that the test to control rather than “control or influence.”

The status of a partner that is not a general partner, however, is inherently one without control. As a result, we suggest that any subjective test reflect a presumption that “control” by a limited partner will be the exception rather than the rule. In this regard, the factors indicating possible de facto “control” provided in the Proposed Regulations do not reflect typical partnership structures. They risk a finding of control even when control does not exist in practice.

The Proposed Regulations provide that any one of the following factors demonstrates that an organization controls a partnership:

(A) The organization, by itself, may require the partnership to perform, or 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

55 Prop. Treas. Reg. §1.512(a)-6(c)(4)(iii).
(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.\textsuperscript{56}

The second and third factors above in the Proposed Regulations are problematic because they deem control to exist no matter how minimal a right an exempt organization’s officers, directors or employees have to participate in the management of the partnership. For example, if a 3% limited partner also has one of its 15 directors serving as a member of the general partner of an investment fund, the organization as a practical matter does not have any right to control the organization.

More generally, the factors use language – “significantly affects the operations of the partnership,” “participate in the management of the partnership,” “conduct the partnership’s business” – defined by state law, rather than federal tax law. State law, however, is inconsistent and varied. For example, court decisions determining whether a particular action or activity constitutes participation in the management of a limited partnership will differ depending on which of the many versions of the Revised Uniform Limited Partnership Act (“RULPA”) a particular state has adopted.\textsuperscript{57} As a result of reliance on state law, an exempt organization limited partner could be deemed to control one partnership and not control a second partnership, even though the organization has identical rights in each partnership. Such inconsistent application seems undesirable from the point of view of both the Service and exempt organizations.

We recommend that the final Regulations, rather than listing negative factors, list factors that serve as safe harbors by describing rights and actions that will not constitute control. Passive partners commonly are afforded a variety of rights. While, in certain cases, some arguably constitute a limited right to “participate” in management, on balance they do not rise to the level of “control.” They are most properly viewed as important means of protecting the partner’s investment. For example, many exempt organization investors have the right to appoint representatives to an investor committee or advisory body. Such a right does not evidence “control,” but instead the right to “participate” in management. Similarly, many exempt organization investors have the right to vote for, approve, or reject the appointment or removal of a general partner. Such rights do not, in our view, evidence control, but rather provide a mechanism to protect the organization’s investment.

\textsuperscript{56} Prop. Treas. Reg. § 1.512(a)-6(c)(4)(iii).

We therefore recommend that Treasury and the Service clarify in the final Regulations that an exempt organization’s right as a partner that is not a general partner in a partnership to vote for or against a number of actions do not individually or collectively, constitute “control” over the partnership. Such a list could include the following rights:

i. to vote for or against the appointment or removal of a general partner;

ii. to approve the selection or removal of a general partner;

iii. to appoint one or more representatives to an investor committee, advisory committee, or similar roles;

iv. to extend the term of the partnership’s “commitment period” or “investment period” (i.e., the term during which the partnership may call capital to make investments) beyond its natural expiration or to continue such period following a “key person” or similar event that otherwise would cause its early termination;

v. to approve or reject replacements of “key persons,” “principals,” or similarly designated individuals constituting the core members of the management group;

vi. to approve or reject “change in control” transactions of the general partner;

vii. to approve or reject the partnership making specific investments, incurring indebtedness, amending the partnership agreement, or otherwise significantly changing its business strategy outside of limitations stated in the partnership agreement, investment policy, private placement memorandum, or other investment document (e.g., “single-issuer” or geographic limitations);

viii. to review and approve (or reject) conflict-of-interest transactions involving the general partner and related parties;

ix. to request, or to review and approve (or reject), valuations of partnership assets;

x. to approve the management group’s ability to establish a “successor fund” prior to the time permitted under the partnership agreement or other investment documents; and

xi. to dissolve or terminate the partnership, with or without cause.
Treasury and the Service also could look to the 1985 amendments to RULPA for guidance regarding the types of activities that do not constitute control,\textsuperscript{58} including:

i. being a contractor for or an agent or employee of the limited partnership;

ii. consulting with and advising a general partner with respect to the business of the limited partnership;

iii. taking any action required or permitted by law to bring or pursue a derivative action in the right of the limited partnership;

iv. requesting or attending a meeting of partners;

v. proposing, approving, or disapproving, by voting or otherwise, one or more of the following matters:
   
   a. the dissolution and winding up of the limited partnership;

   b. the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership;

   c. the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;

   d. a change in the nature of the business;

   e. the admission or removal of a general partner;

   f. the admission or removal of a limited partner;

   g. a transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners;

   h. an amendment to the partnership agreement or certificate of limited partnership, or

\textsuperscript{58} The list above derives from section 303 of the 1985 version of RULPA, available at: 
i. matters related to the business of the limited partnership that the partnership agreement states in writing may be subject to the approval or disapproval of limited partners.

In short, the variations in state law and the broad language of the factors currently listed under Prong 2 raise concerns. We recommend that Treasury and the Service replace its current list of negative factors with a set of factors that provide safe harbors. If the Treasury and the Service feel the need to retain the current list of negative factors, we recommend that the final Regulations include as well a list of safe harbor activities that will not constitute participating in control of a partnership.

3. **Indirect or Look-Through Test**

The Proposed Regulations provide a special rule under which indirectly held partnership interests can qualify as QPIs even if they fail Prong 1 (discussed above) because the exempt organization holds more than a 20% capital interest in an upper-tier partnership (“UTP”).\(^{59}\) This special rule permits an organization to treat an indirect interest as a QPI apply even if (1) the organization holds more than 20% of the capital interests in the UTP so long as (2) the organization does not actually control the UTP under the facts and circumstances test (Prong 2 discussed above). Under these rules, a lower-tier partnership (“LTP”) can be considered a QPI only if the organization satisfies the *De Minimis* Test with respect to the LTP.

The Proposed Regulations provide an example in which the organization holds 50% of the capital interests of UTP, but does not “control” it under the Prong 2.\(^{60}\) The directly held UTP, in turn, owns 4% of LTP-A, and therefore the organization indirectly holds only 2% of the LTP-A, enabling it to elect to treat the lower-tier partnership as a QPI. However, in the example, when the directly held partnership owns 10% in LTP-B, the organization cannot treat LTP-B as a QPI because it effectively owns 5% of LTP-B. For LTP-B, then, the organization will need to determine the NAICS codes for LTP-B’s activities.

We recommend that the final Regulations provide that an LTP can be a QPI if the organization can satisfy both prongs of the Control Test with respect to the LTP. We further recommend that Prong 2 of the Control Test be satisfied with respect to an LTP in which an organization has no direct interest if either the organization does not control the UTP or the UTP does not control the LTP. That is, even if an organization has control over a UTP, if that UTP does not control an LTP, the organization would also lack the ability to control the LTP (assuming it has no separate, direct interests in the LTP) and thus should satisfy Prong 2 with

\(^{59}\) Prop. Treas. Reg. § 1.512(a)-6(c)(2)(ii).

\(^{60}\) Prop. Treas. Reg. § 1.512(a)-6(c)(2)(iii).
respect to that LTP. Furthermore, if the UTP indirectly owns the LTP through one or more intervening partnerships, the UTP should be deemed not to control the LTP if any of the intervening partnerships do not control a partnership beneath it in the chain ending in the LTP. Under this approach, in the example above, LTP-B would be a QPI because the organization holds less than 20% of B’s capital interest and does not control UTP. Similarly, LTP-B would be a QPI even if the organization did control UTP, as long as UTP did not control LTP-B. We do not believe an indirect interest in an LTP should be subject to a stricter ownership requirement than a direct interest in a UTP.

As a practical matter, it will be difficult for organizations to obtain the necessary NAICS codes information from LTPs. Moreover, if the De Minimis Test applies to LTPs, it would seem that the Control Test should as well. If an organization’s indirect interest in an LTP satisfies both prongs of the Control Test, then it seems to us to meet the intent of the Proposed Regulations. In our view, interposition of a UTP should not change that result.

4. QPI - Examples

We recommend that the final Regulations provide specific examples of the operation of the De Minimis and Control Tests in both direct and indirect situations. We offer the following as proposed examples. These examples use a 2% De Minimis Test, even though we are recommending 5%, and a 20% Control Test, even though we are recommending 50%. They do, however, include examples reflecting our view that an organization should be able to meet the Control Test as well as the De Minimis Test indirectly.

a. De Minimis Test Met

Example 1. Z is an exempt organization that acquired a 0.5% limited partnership interest in Partnership A. The limited partnership interest gives Z a 0.5% profits and capital interest in Partnership A. Because Z holds directly no more than 2% of the profits and capital interest in Partnership A, Z’s interest in Partnership A meets the requirements of the De Minimis Test and therefore Partnership A is a QPI.

b. De Minimis Test Met—Related Interests Not Taken into Account

Example 2. Assume the same facts as Example 1, except that Z has a supporting organization, S, that owns 3% of the profits and capital interest in Partnership A. Z’s interest in Partnership A continues to meet the requirements of the De Minimis Test and is therefore a QPI. When determining an organization’s percentage interest in a partnership for purposes of the De Minimis Test, related interests (the interests of a supporting organization or a controlled entity) in the same partnership are not taken into account.

c. No Control under Control Test
Example 3. X is an exempt organization that acquired a 3% limited partnership interest in Partnership B. The limited partnership interest gives X a 3% interest in profits and a 3% interest in capital in Partnership B. X does not control the partnership within the meaning of paragraph (c)(4)(iii) of the Regulations. X has no supporting organizations or controlled entities. Because X holds directly more than 2% of the profits and capital interest in Partnership B, X’s interest in Partnership B does not meet the requirements of the De Minimis Test. However, because X holds no more than 20% of the capital interest in Partnership B and does not control Partnership B within the meaning of paragraph (c)(4)(iii) of the regulations, X’s interest in Partnership B meets the requirements of the Control Test and is therefore a QPI.

d. Control Test Not Met—Related Interests Taken into Account

Example 4. Assume the same facts as Example 3, except that X has a supporting organization, S, that owns 18% of the capital interests in Partnership B. X no longer meets the requirements of the Control Test because its aggregate percentage interest in Partnership B exceeds 20% (3% + 18% = 21%). X’s interest in Partnership B is not a QPI and must be reported using NAICS 2-digit codes.

e. Proposed Satisfaction of Look-Through Rule When Control Test Satisfied

Example 5. Y is an exempt organization that acquired a 50% limited partnership interest in Partnership D after August 21, 2018. The limited partnership interest gives Y a 50% profits and capital interest in Partnership D. Y does not control the partnership within the meaning of paragraph (c)(4)(iii) of the Proposed Regulations. Partnership D owns an interest in two lower-tier partnerships as follows: Partnership D owns a 4% profits and capital interest in Partnership D1, and a 10% profits and capital interest in Partnership D2. Because Y holds directly more than 2% of the profits and capital interest in Partnership D, Y’s interest in Partnership D does not meet the requirements of the De Minimis Test. Also, because Y holds more than 20% of the capital interest in Partnership D, Y’s interest in Partnership D does not meet the requirements of the Control Test. However, Y indirectly holds 2% of the profits and capital interest in Partnership D1. Thus, Y’s interest in Partnership D1 meets the requirements of the De Minimis Test. In addition, Y indirectly holds 5% of the capital interest in Partnership D2. Because Y does not control Partnership D and indirectly holds less than 20% of the capital interest in Partnership D2, Y’s interest in Partnership D2 meets the Control Test. Thus, Y’s interest in both Partnerships D1 and D2 are QPIs.

f. Proposed Satisfaction of Look-Through Rule—EO Controls Upper-Tier Partnership 20% or Less Indirect Control over Lower-Tier Partnership
Example 6. Assume the same facts in Example 5 above, except that Y controls Partnership D within the meaning of paragraph (c)(4)(iii) of the regulations by virtue of specified provisions in the partnership agreement. Partnership D, however, does not control Partnership D2. Even though Y controls Partnership D, and Y holds indirectly more than 2% of the profits and capital interest in Partnership D2 and thus does not meet the requirements of the De Minimis Test, Y’s interest in Partnership D2 meets the requirements of the Control Test. Thus, Y’s interest in Partnership D2 is a QPI.

g. Non-QPI Because of General Partnership Interest

Example 7. T is an exempt organization that acquired a 1% general partnership interest in Partnership G. Because T is a general partner in Partnership G, T’s interest in Partnership G is not a QPI.

h. Partnership Transition Rule.

Example 8. (i) Y is an exempt organization that acquired a 50% limited partnership interest in Partnership D before August 21, 2018. The limited partnership interest gives Y a 50% profits and capital interest in Partnership D. Y does not control the partnership within the meaning of paragraph (c)(4)(iii) of the regulations. Because Y holds directly more than 2% of the profits and capital interest in Partnership D, Y’s interest in Partnership D does not meet the requirements of the De Minimis Test. Also, because Y holds more than 20% of the capital interest in Partnership D, Y’s interest in Partnership D does not meet the requirements of the Control Test. Y’s interest in Partnership D is not a QPI. Because Y’s interest in Partnership D was acquired before August 21, 2018, the transition rule applies. Under the transition rule, Y may treat Partnership D as a separate unrelated trade or business regardless of the number of unrelated trades or businesses directly or indirectly conducted by Partnership D.

(ii) Y’s percentage interest in Partnership D increased to 60% when another investor redeemed its interest in the partnership. Y may continue to apply the transition rule to its interest in Partnership D.

5. Reliance on Schedule K-1

The Proposed Regulations are consistent with Notice 2018-67 by allowing an exempt organization to compute its percentage interest in a partnership by relying on Schedule K-1 (Form 1065). Specifically, an exempt organization may rely on the profit and capital percentages reported on the Schedule K-1 it receives from a partnership for purposes of the De Minimis and Control Tests. The organization computes its percentage interest by taking the average of its

61 An example of the transition rule is included here with other examples. Explanation of the Partnership Transition Rule is set forth infra.

62 Prop. Treas. Reg. § 1.512(a)-6(c)(5). This proposed regulation adopts a similar rule for S corporation interests and reliance on Schedule K-1 (Form 1120-S).
percentage interest at the beginning and the end of the partnership’s taxable year
(or the beginning and end of the period of ownership during the taxable year, if
shorter).

The Proposed Regulations limit such reliance to a Schedule K-1 that lists
either or both of the exempt organization’s percentage profits and capital interest
at the beginning and end of the year. In the event that the Schedule K-1 lists the
percentages as “variable,” the Proposed Regulations clarify that the exempt
organization may not rely on it.63

The Proposed Regulations liberalize the mandate set forth in Notice 2018-
67 and do not require the exempt organization to rely on the Schedule K-1 in
order to satisfy the De Minimis Test. In the December 2018 Comments, we noted
that tax-exempt partners have difficulty obtaining information not presented with
the Schedule K-1 (including footnotes).

We support reliance criteria of the Proposed Regulations, specifically with
regard to permitting exempt organizations to rely on the Schedule K-1 rather than
mandating it. We recommend, however, that the final Regulations identify
additional facts and circumstances that a tax-exempt partner could use to
demonstrate that its percentage interest in a partnership falls below the thresholds
for either the De Minimis Test or Control Test.

In a world of ideal tax compliance, the existing rules governing
partnership reporting, including the instructions to the Form 1065, would ensure
that partnerships will provide the required percentages for tax-exempt partners to
determine whether they meet the ownership thresholds for the De Minimis or
Control Tests. Section 6031(d) requires a partnership to provide tax-exempt
partners “such information as is necessary to enable each partner to compute its
distributive share of partnership income or loss from such trade or business in
accordance with section 512(a)(1).” In addition, the Form 1065 instructions for
Item J, “Partner’s Profit, Loss, and Capital,” state that “the partner’s percentage
share of each category must be expressed as a percentage.” Nonetheless,
partnerships may not always provide complete information. We, therefore,
recommend that the final Regulations permit an exempt organization to use
alternative reasonable methods to determine its percentage interests if it does not
rely on the Schedule K-1. For example, the final Regulations could permit a tax-
exempt partner to request supporting information from the partnership or to rely
upon the partnership agreement’s fixed percentages, if any.

We further recommend that the final Regulations provide phase-in and
grace periods to address certain delays and fluctuations that are beyond the
control of an exempt organization. Specifically, because private investment funds
often admit limited partners in waves (“closings”) over the course of several
months at the beginning of the fund’s term, we recommend that holdings for a

63 Prop. Treas. Reg. § 1.512(a)-6(c)(5)(i).
new partnership be calculated as of the date of the final closing of the partnership, so long as the final closing is no more than 18 months following the partnership’s initial closing. In addition, we recommend that the Proposed Regulations provide that an exempt organization is permitted up to 90 days to reduce its interest in a partnership below the relevant limits in any case where its percentage interest increased because of another partner’s withdrawal or percentage reduction. This type of provision would be similar to the 90-day grace period under section 4943 for excess business holdings acquired other than by purchase.

C. S Corporations

We appreciate that the Proposed Regulations add guidance with respect to S corporations, a category that Notice 2018-67 did not address. Generally, the Proposed Regulations provide that flow-through income from each S corporation is treated as a separate trade or business.64 However, under the Proposed Regulations, interests in qualifying S corporations (determined under the same rules applicable to determination of qualifying partnership interests, above) are added to the investment silo.65

We agree that when the exempt organization’s ownership of an S corporation satisfies the Control or De Minimis Tests, the interest in the S corporation should be treated in the same manner as a qualifying partnership interest.

We also support the position in the Proposed Regulations that gains or losses from dispositions of qualifying S corporation interests be included in the investment silo. The rule that treats all gains and losses from the disposition of S corporation interests as UBTI is unique; thus, we think that grouping these gains or losses with the investment silo is reasonable.66

With respect to other S corporation interests, we respectfully disagree with the treatment of each S corporation as a separate trade or business.67 Under this approach, if an exempt organization owns interests in two S corporations engaged in identical activities, gains and losses cannot be offset or applied against other similar income from directly operated businesses.

We recommend that the final Regulations treat S corporations like partnerships. That is, when an S corporation is not a qualifying S corporation interest, the activity should be assigned a NAICS code in the same way as partnership interests that are not qualifying partnership interests.

D. Income from Controlled Entities.

64 Prop. Treas. Reg. § 1.512(a)-6(c)(e)(1).
65 Prop. Treas. Reg. § 1.512(a)-6(e)(2); -6(c)(1)(ii).
66 Prop. Treas. Reg. § 1.512(a)-6(e)(1).
67 Prop. Treas. Reg. § 1.512(a)-6(e)(1).
Section 512(b)(13) provides that certain income from controlled organizations that would be otherwise excluded from UBTI under section 512(b)(1), 512(b)(2), or 512(b)(3) is included in the controlling organization’s UBTI. Under the Proposed Regulations, section 512(b)(13) UBTI income received by a controlling organization will not be included in the investment income silo with income from debt-financed property and qualified partnerships and S corporations.68 The Proposed Regulations also provide that income from each separate controlled organization will be in a separate silo.

We recommended in the December 2018 Comments that income or loss deemed to be UBTI by virtue of sections 512(b)(4) and 512(b)(13) be included in an investment silo.69 The Preamble to the Proposed Regulations rejected the inclusion of UBTI created by section 512(b)(13) in an investment silo.70 The Preamble explains that combining section 512(b)(13) income with investment income is inconsistent with the purpose of section 512(b)(13). That purpose, the Preamble states, is to prevent an entity controlled by an exempt organization from gaining a competitive advantage through making deductible payments to a controlling organization. According to the Preamble, section 512(b)(13) “views such payments as stemming from the trade or business activity of the controlled entity rather than from the ‘investment activity’ of the controlling organization.”71

The legislative history of the Taxpayer Relief Act of 1997, which strengthened the provisions of section 512(b)(13), points out that even if payments from controlled organizations are not inflated, “section 512(b)(13) is intended to prevent a tax-exempt parent from obtaining what is, in effect, a tax-free return on capital invested in its subsidiary.”72 Thus, we recommend that the final Regulations treat section 512(b)(13) UBTI as investment income that may be allocated to the investment income silo.

Alternatively, we recommend the final Regulations permit there to be one silo for all section 512(b)(13) income, regardless of the source of the income. For many organizations the activities of controlled subsidiaries are closely related. It would be both efficient and logical to permit organizations to aggregate all section 512(b)(13) income.

As we explain further below, having a separate silo for income from each controlled organization will yield different results for fact patterns that are in substance the same. Further, having a separate silo for each controlled organization could encourage exempt organizations to restructure financial arrangements between controlling and controlled organizations to replicate the tax consequences of a single silo. As a result, organizations with sophisticated legal advice will benefit, while others will not. The example below illustrates these points.

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68 Prop. Treas. Reg. § 1.512(a)-6(d).
70 Preamble, supra note 8, at 23,184–85.
71 Preamble, supra note 8, at 23,185.
The facts in the example, and in each of the four scenarios, are as follows. A tax-exempt hospital (Parent) has two controlled organizations, Sub 1 and Sub 2. The lines of control vary in each scenario.

Sub 1 is a tax-exempt entity that provides outpatient medical care. Its only activity unrelated to its exempt purposes is the operation of an outpatient pharmacy located in the hospital building. Sub 1 rents the pharmacy space for $30,000 per year. Sub 1’s net income from the pharmacy before deduction of rent is $50,000 per year. Thus, the entire rent payment reduces Sub 1’s UBTI. Parent’s allocated expenses directly connected with the rental of space are $35,000 per year.

Sub 2 is a taxable entity that operates community-based retail pharmacies. All of its income is from activities that would be UBTI were they conducted by Parent or Sub 1. Sub 2 rents buildings in the community owned by Parent or Sub 1, depending on the scenario. Sub 2 pays rent of $25,000 per year. Sub 2’s net income before deduction of rent is $35,000 per year. Thus, the entire rent payment reduces the amount of UBTI that Sub 2 would have were it exempt. The Parent’s allocated expenses directly connected with the rental of space are $15,000 per year.

The four scenarios described below, with varying corporate ownership structures and leasing arrangements, result in different amounts of UBTI under the Proposed Regulations’ separate silo structure.
**Scenario 1.** In Scenario 1, Parent controls Sub 1, and Sub 1 owns Sub 2. Each of Sub 1 and Sub 2 lease property directly from Parent.

The Parent-Sub 1 silo includes $30,000 rent paid by Sub 1. Parent’s expenses deductible from the rent are $35,000, resulting in a $5,000 loss. The Parent-Sub 2 silo includes $25,000 rent paid by Sub 2 and $15,000 in Parent expenses, resulting in net income of $10,000. Because a silo cannot have UBTI less than zero, Parent has UBTI from section 512(b)(13) of 0 (Sub 1) plus $10,000 (Sub 2), or $10,000 in total.
**Scenario 2.** In Scenario 2, Parent controls Sub 1 and Sub 1 owns Sub 2. Sub 1 leases property from Parent and subleases some of this property to Sub 2.

Sub 1 receives $25,000 in rent from Sub 2. Sub 1 includes this rent as UBTI from a controlled entity. Sub 1’s expense is $25,000 (because it pays the rent directly to Parent), resulting in net section 512(b)(13) UBTI for Sub 1 of 0. Parent receives $25,000 plus $30,000, or $55,000, in rent from Sub 1. All of the rent paid by Sub 1 to Parent reduced Sub 1’s UBTI. Parent has UBTI of $55,000 minus expenses of $15,000 as well as a directly allocated expense of $35,000, or $50,000. Parent has net 512(b)(13) UBTI of $5,000.
**Scenario 3.** In Scenario 3, Parent controls each of Sub 1 and Sub 2 directly and receives rent from each of Sub 1 and Sub 2.

The result with separate silos for Parent-Sub 1 and Parent-Sub 2 is the same as in Scenario 1. The Parent-Sub 1 lease results in a loss of $5,000 for Parent, which is treated as 0 when all the silos are combined. The Parent-Sub 2 lease results in UBTI of $10,000 for Parent.
Scenario 4. In Scenario 4, the Parent leases all property to Sub 1 and Sub 1 subleases some of the property to Sub 2.

The rent received by Parent for the space used by Sub 1 is subject to section 512(b)(13) because it is rent received by a controlling organization and the rent reduced Sub 1’s UBTI from the activity. Is the rent received by Parent for the space leased to Sub 1 and subleased to Sub 2 taxable under section 512(b)(13)? Arguably, it is not because Sub 1 did not use that rent deduction to reduce Sub 1’s UBTI; Sub 1 did not receive the rent from a controlled entity and thus would not be subject to section 512(b)(13). Therefore, Parent’s section 512(b)(13) silo consists only of the $30,000 rent received for the space used by Sub 1 less the $35,000 expense related to that rent, or a loss of $5,000. Parent has no UBTI and has a loss of $5,000 to carry over in that silo.

In summary, these scenarios demonstrate how having separate silos for income received from each controlled entity produces varying results for otherwise identical economic consequences. We believe that allowing one silo for income received from all controlled entities produces fairer and more consistent results.

E. Subpart F, GILTI, and Foreign Insurance Income

We support Prop. Treas. Reg. § 1.512(b)-1(a)(1) and (3), which now specifically treat Subpart F income under section 951(a)(1)(A) and GILTI under section 951A(a) in the same manner as a dividend, which is excluded from the UBTI under section 512(b)(1). We also concur with Prop. Treas. Reg. § 1.512(a)-6(d)(2), which provides that all foreign insurance income described in section 512(b)(17) shall be isolated into a
separate silo. We do not recommend any changes to these portions of the Proposed Regulations.

F. Net Operating Losses

The Proposed Regulations provide that for post-2018 tax years the NOL deduction is tracked separately for each trade or business of the taxpayer.\(^{73}\) An organization may deduct pre-2018 NOLs from total UBIT before deducting post-2017 NOLs with regard to a separate unrelated trade or business in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year.\(^{74}\) We agree with these rules, and, in particular, believe that the ordering rule described in the preceding sentence is the best interpretation of section 512(a)(6) and section 13702(b)(2) of the Act.

As discussed in the Preamble, shortly prior to the promulgation of the Proposed Regulations, the President signed the CARES Act,\(^{75}\) which temporarily modifies certain rules with respect to usage of NOLs. We recommend that the final Regulations reflect the CARES Act in a manner that allows exempt taxpayers flexibility to maximize the economic value of their NOLs consistent with the CARES Act’s intention to provide relief to taxpayers in light of the novel coronavirus.

In Frequently Asked Questions issued on June 8, 2020,\(^{76}\) the Service indicated that an exempt organization subject to section 512(a)(6) can deduct NOLs available as a result of the CARES Act (“CARES Act NOLs”) against the aggregate UBTI in a taxable year beginning before January 1, 2018. Also, an exempt organization may carry back CARES Act NOLs attributable to an unrelated trade or business, even if the exempt organization would not have had a CARES Act NOL if the deduction in the relevant taxable year were calculated on an aggregate basis.

The Service also noted that the special rule in the Act that allows NOLs arising in taxable years beginning before January 1, 2018, to be deducted against aggregate UBTI does not apply to CARES Act NOLs because those NOLs arise in taxable years beginning after December 31, 2017.

Because these frequently asked questions do not have the force of regulations, we recommend that the final Regulations include these provisions.

In addition, as set forth in our prior comments,\(^{77}\) we would appreciate that Treasury and the Service consider providing guidance, whether in the final Regulations, or otherwise, with respect to:

\(^{73}\) Prop. Treas. Reg. § 1.512(a)-6(h)(1).
\(^{74}\) Prop. Treas. Reg. § 1.512(a)-6(h)(1).
\(^{77}\) December 2018 Comments, supra note 3, at 21–23.
(1) whether NOLs in a silo remain available if an organization ceases and later resumes the activity in the silo (we recommend continued availability); and

(2) coordination of NOLs with the charitable deduction under section 512(b)(10).

G. Social Clubs, VEBAs, and SUBs.

We support the Proposed Regulations that generally treat unrelated trade or business activities for social clubs, VEBAs, and SUBs in the same way as other tax-exempt organizations for purposes of section 512(a)(6). We are also in agreement with the treatment of taxable investment income for these purposes. The following comments are primarily limited to social clubs that are tax exempt under section 501(c)(7) (“Social Clubs”).

1. Nonrecurring Events.

The Proposed Regulations provide that whether a nonrecurring event is a separate activity or part of another activity depends on the facts and circumstances of the event and the particular Social Club. Treasury and the Service requested comments regarding the particular facts and circumstances to be taken into account in determining whether such an activity should be considered part of a larger trade or business or part of investment income. We recommend the final Regulations provide that Social Clubs may consider the following non-exclusive list of facts and circumstances in making this determination:

a. Does the event qualify as taxable income from a trade or business activity?

b. Considering the organization’s history and plans for the future, is the activity likely to recur over the next five years?

c. Is gross income from the activity at least $1,000?

d. Does the activity relate to the sale or exchange of property that otherwise produces taxable income?

e. Does the activity relate to the sale or exchange of property that otherwise produces taxable income that is classified in a separate silo?

f. Does the activity relate to the sale or exchange of property that otherwise produces taxable investment income?

2. Further recommendations.

78 Prop. Treas. Reg. § 1.512(a)-6(c)(8).
79 Preamble, supra note 8, at 23,189.
In the case of Social Clubs, rent from real estate may produce either related or taxable investment income. Moreover, in some cases only a portion of rent may qualify for exclusion from income under section 512(b)(3). We recommend that in most cases a reasonable approach would be to fragment the income for purposes of section 512(a)(6).

For example, consider a Social Club that has a property from which it earns rental income that would be taxable as investment income and income from the direct activity of renting out the property’s hall for events that would otherwise produce unrelated business income. Using a fragmentation rule in this type of situation, the rental income that qualifies as investment income would be aggregated with other investment income and the direct activity that produces income from events would be classified using the NAICS system. This approach is administratively feasible and has been used with success in other areas of tax law. We recommend, however, that fragmentation not apply if all the income from the property qualifies as nontaxable.

H. Public Support

The Proposed Regulations state that section 512(a)(6) does not apply to the public support calculations made under either section 170(b)(1)(A)(vi) and 509(a)(2).\(^{80}\) The public support tests set out, respectively, in Treas. Reg. § 1.170A-9(f) and Treas. Reg. § 1.509(a)-3, enable certain 501(c)(3) organizations to avoid characterization as a private foundation (collectively, “the public support tests”). For decades, the tests have involved a calculation in which the denominator, a measure of overall support, includes “net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business,” as required by section 509(d)(3). Thus, no matter how organizations satisfy the public support tests, they have long been required to determine their net income from all of their unrelated business activities.

The Proposed Regulations recognize that section 509(d)(3), the provision describing net UBTI for purposes of the public support tests, establishes an umbrella that encompasses all revenue streams coming from trade or business activities that do not constitute exempt-function activity. Section 509(d)(3) includes in its definition activities that are not regularly carried on.\(^{81}\) That is, the provision regarding public support do not define or treat UBTI in the same way as section 512(a)(6), and section 512(a)(6) does not affect how organizations report net income under the public support tests.

However, because of section 512(a)(6), reporting is, and will continue to be, significantly more complicated for taxpayers using one of the public support tests, the section 509(a)(2) test that applies to organizations with gross receipts related to their exempt purpose (“Gross Receipts Test”). For this test, the requirement under section 509(d)(3) to report net income on unrelated activities now must be divided into two buckets—one taking into consideration the net income from unrelated trade or business activities...
operations that are subject to unrelated business income taxation under section 511, i.e., their “UBTI,” and the other taking into consideration the net revenues from unrelated business activities that are not taxed under 511. This bifurcation is necessary so that the first bucket can be calculated in a particular “not more than one-third test” related to sources of revenue, including UBTI, used for the Gross Receipts Test.

As a result of section 512(a)(6), many taxpayers will see an increase in UBTI because they can no longer use losses from one unrelated trade or business to offset income from another unrelated trade or business. For taxpayers that qualify as publicly supported under the Gross Receipts Test, such a result will distort the calculation of the section 509(a)(2) test in a manner that is inconsistent with Treas. Reg. § 1.509(a)-3.

We support the understanding that Congress did not intend to change the Gross Receipts Test when enacting section 512(a)(6). Accordingly, we recommend that the final Regulations clarify both:

(1) that an organization with more than one unrelated trade or business should aggregate its net income and net losses from all of its unrelated business activities, other than those that are not an unrelated trade or business within the meaning of section 513, and regardless of whether or not an unrelated business activity is regularly carried on, for purposes of determining total support under section 509(a)(2); and

(2) that only the allocable net income from unrelated trades or businesses that are subject to UBIT within such total support is to be taken into account for purposes of determining whether the organization meets the not-more-than-one-third support test under Reg. § 1.509(a)-3(a)(3) for purposes of being “publicly supported” under the Gross Receipts Test.

We appreciate the recognition in the Proposed Regulations “that requiring different calculations for purposes of determining public support and UBTI may impose a significant administrative burden on organizations with more than one unrelated trade or business.”82 This burden could be alleviated if the amount required to be calculated as net income generated by unrelated activities under the public support tests excluded amounts from activities that are not an unrelated trade or business within the meaning of section 513.

I. Transition Reliance Rules

Treasury and the Service have recognized the need for transition relief for exempt organizations to comply with the new rules under section 512(a)(6).

1. General Transition Rules

The Regulations are proposed to apply to taxable years beginning on or after the date the Regulations are published in the Federal Register as final.

82 Preamble, supra note 8, at 23,191.
Regulations. The Preamble of the Proposed Regulations provides that, for taxable years beginning before the date the Regulations are published in the Federal Register as final Regulations, an exempt organization may rely on a reasonable, good-faith interpretation of sections 511 through 514, considering all the facts and circumstances, when identifying separate unrelated trades or businesses for purposes of section 512(a)(6)(A). In addition, for these same taxable years, an exempt organization may rely on the Proposed Regulations in their entirety. Alternatively, for these same taxable years, an exempt organization may rely on the methods of aggregating or identifying separate trades or businesses provided in the Notice 2018-67 (collectively “Transition Reliance Rules”).

We suggest a longer transition period. Analyzing and applying the final Regulations will involve making new kinds of allocations of expenses and revenues as well as implementing needed changes to accounting systems. We believe all affected organizations should have at least one year of transition time before being required to use the final Regulations. We further recommend that exempt organizations be allowed to rely upon the Transition Reliance Rules during the recommended extended transition period. Specifically, we recommend that Treasury and the Service permit exempt organizations to apply the Transition Reliance Rules until the first day of the second taxable year beginning after the date the final Regulations are published in the Federal Register.

Requiring exempt organizations to implement a new accounting rule for their unrelated business taxable income for taxable years beginning on or after the date the final Regulations are published in the Federal Register could provide little or no transition time for many exempt organizations (as well as the partnerships that issue Schedules K-1 to them) to adjust their books and records, systems and processes to comply with the final Regulations. If, for example, Treasury and the Service meet their goal of publishing final Regulations in 2020, tax-exempt organizations on a calendar year may have only a matter of weeks or days to transition to the rules as set forth in the final Regulations. If the final Regulations were published in the spring of 2021, tax-exempt organizations with tax years ending in June would have a very short transition time.

Delaying the effective date of the final Regulations until the second taxable year beginning after the publication of the final Regulations would give all tax-exempt organizations at least one full year to implement the new rules, regardless of when the regulations are published. Even if the rules in the final Regulations largely resemble the Proposed Regulations and Notice 2018-67, many tax-exempt organizations will have been relying on various reasonable, good-faith interpretations of the statute prior to the publication of the final Regulations. They will need sufficient time to identify business activities that may be combined in appropriate NAICS codes, make appropriate allocations of revenues and expenses, adjust systems and processes, including reprogramming of computer systems, and otherwise implement the final Regulations. Moreover,

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83 Preamble, supra note 8, at 23,192.
because proposed regulations can significantly change as a result of the notice and comment process, organizations may wait until the regulations have been finalized to begin the implementation process. Otherwise, they risk having to duplicate effort—and incur additional expense—when final Regulations are issued.

Extending reliance on the Proposed Regulations alone is not sufficient. If organizations currently relying on a reasonable interpretation of the statute can rely on the Proposed Regulations only for a relatively short transition period, organizations would be effectively forced to comply with a rule that has not gone through the notice and comment process. Further, if an exempt organization changes its books and records as well as its systems and processes for accounting to comply with the Proposed Regulations and then must make additional changes after the final Regulations are issued, the cost and administrative burden of compliance is increased. Such an outcome would place an unnecessary administrative burden on exempt organizations and be contrary to the intent of Executive Order 13789 to reduce regulatory burdens on taxpayers.84 Thus, the recommended transition period would further this Executive Order as well as the general policy goal of reducing administrative burdens. In addition, a longer period is consistent with the transition relief routinely provided for other taxpayers required to make significant changes to accounting methods and systems.85

2. Partnership Transition Rules

We appreciate that the Proposed Regulations also include a special transition rule for partnership interests. Directly held partnership interests acquired prior to August 21, 2018, are treated 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, and even if the organization’s percentage interest in such partnership changes before the end of the transition period (the “Partnership Transition Rule”).86 However, the Proposed Regulations allow reliance on the Partnership Transition Rule only until the first day of the organization’s first taxable year beginning after the date the regulations are published in the Federal Register as final Regulations.87 Again, this period is not long enough.

To avoid administrative burden for exempt organizations, we recommend that an exempt organization be permitted to rely upon the Partnership Transition Rule until the exempt organization disposes of the subject partnership interest. That is, we recommend that the Partnership Transition Rule effectively serve as a

85 See, e.g., Notice 2016-08, Section II(B), 2016-1 C.B. 304 (FATCA transition rules).
86 Prop. Treas. Reg. § 1.512(a)-6(c)(7).
87 Prop. Treas. Reg. § 1.512(a)-6(c)(7)(iii).
grandfather rule. The use of the Partnership Transition Rule is limited in availability solely to interests acquired prior to the issuance of Notice 2018-76. We note that the Proposed Regulations provide that partnership interests treated as a separate trade or business under the Partnership Transition Rule cannot be aggregated with other partnership interests and that the Partnership Transition Rule cannot be combined with the look-through rule. As a result, the use of this transition rule is quite restrictive. There would not seem to be potential for undue expansion or abuse of this Partnership Transition Rule. Further, given that Treasury and the Service viewed this treatment of a partnership interest acquired prior to the issuance of Notice 2018-76 as permissible for the transition period, it would seem that such an interest could continue to be treated as a separate trade or business until disposed. Indeed, Treasury and the Service have adopted similar grandfather rules in the past.

In addition, many tax-exempt organizations have been using the Partnership Transition Rule for partnerships with various businesses (including the businesses of lower-tier partnerships) that generated NOLs in tax years beginning in 2018 and afterward. Consistent with the Partnership Transition Rule, these NOLs have been computed at the level of, and assigned to, the partnership as a whole, with the understanding that these NOLs could only be carried forward and used against future UBTI from that partnership as a whole. If these organizations were to lose the ability to use the Partnership Transition Rule for these partnerships, they would need to start computing UBTI for each of the partnerships’ trades or businesses in the same way as other business activities, using the appropriate NAICS codes. Such a change would complicate use of the post-2017 NOLs. Organizations had no prior need to further disaggregate the NOLs by separate trades or businesses carried out by the partnership (or lower-tier partnerships). They will have no ability to do so if the Partnership Transition Rule lapses. To avoid undue burden on such organizations, NOLs that arose under the Partnership Transition Rule at the partnership level should continue to be made available for use against any of the organization’s UBTI from that partnership under the Partnership Transition Rule.

In sum, the Proposed Regulations provide the possibility of little or no transition time. As a result, organizations now may be concerned about how they can comply if final Regulations are issued before year-end without transition relief. Thus, we recommend that Treasury and the Service proactively announce that any final Regulations will include at least one year for all organizations to implement the provisions of the final Regulations.

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88 Prop. Treas. Reg. § 1.512(a)-6(c)(7)(ii).
89 See, e.g., Treas. Reg. § 1.752-2(l)(3), granting taxpayers with so-called “bottom dollar” guarantees transition period relief of up to seven years during which they are not required to apply the new rules with respect to bottom dollar guarantees under certain circumstances.