AICPA

November 19, 2019

Ms. Stephanie N. Robbins
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1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Jonathan Carter
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Re: Notice 2018-67 – Request for Comments Regarding the Calculation of Unrelated Business Taxable Income under Section 512(a)(6) for Exempt Organizations with More than One Unrelated Trade or Business; Interim and Transition Rules for Aggregating Certain Income Investments; and the Treatment of Global Intangible Low-Taxed Income Inclusions for Purposes of the Unrelated Business Income Tax

Dear Ms. Robbins and Mr. Carter:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS or "Service") to address the need for guidance related to new section 512(a)(6)[1] as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA).

On August 21, 2018, Treasury and the IRS issued Notice 2018-67 ("Notice"). This letter is our initial response to the request for feedback on the rules described in the Notice and certain other issues related to section 512(a)(6).

Specifically, the AICPA provides recommendations on the following issues:

I. *De Minimis* Exception for Trades or Businesses

II. Separate Trades or Businesses
   1. Use of Other Code Sections
   2. NAICS Codes
   3. Use of Any Reasonable Method

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

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We appreciate your consideration of our comments. If you have any questions, please contact Richard Locastro, Chair, AICPA Exempt Organizations Taxation Technical Resource Panel, at (301) 951-9090, rlocastro@grfcpa.com; Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
Ms. Amber Salotto, Attorney Advisor, Department of the Treasury
Ms. Elinor Ramey, Attorney Advisor, Department of the Treasury
Ms. Tamera Ripperda, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service

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AMERICAN INSTITUTE OF CPAs

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BACKGROUND

In general, organizations described in sections 401(a) and 501(c) are exempt from federal income tax. However, a tax on the unrelated business taxable income (UBTI) of organizations described in section 511(a)(2) and trusts described in section 511(b)(2) is imposed by section 511(a)(1). These organizations are referred to as "tax-exempt organizations" or "exempt organizations" in this letter.

Prior to the enactment of the TCJA, tax-exempt organizations could aggregate the income and losses from all unrelated, regularly carried on active trades or businesses to calculate UBTI. They could reduce the overall net taxable income by netting the loss generated from one unrelated activity with the net taxable income of another dissimilar activity.

The TCJA created new section 512(a)(6), which requires the separate computation of UBTI for each trade or business of a tax-exempt organization subject to the unrelated business income tax (UBIT). Therefore, tax-exempt organizations must calculate the UBTI of each trade or business separately without netting the losses from one unrelated activity against the income of another activity. The provision is effective for tax years beginning after December 31, 2017.

SPECIFIC COMMENTS

I. *De Minimis* Exception for Trades or Businesses

Overview

According to new section 512(a)(6), *all* organizations (not only larger entities, such as colleges or universities that can more easily track separate unrelated activities) to which the UBIT rules apply are precluded from offsetting profits from one unrelated activity with losses from another. Section 512(a)(6) makes no exception for small tax-exempt organizations.

The new computation requirement of section 512(a)(6) represents a significant departure from previous law. It will necessitate the tracking of separate unrelated business income (UBI) activities of tax-exempt organizations. Additionally, tax-exempt organizations with more than one unrelated trade or business will need to track carryover losses by activity.

The segregation of unrelated business activity losses, as required by section 512(a)(6), likely originated in the IRS's *Colleges and Universities Compliance Project Final Report* (the "Final

Report") before it was proposed in former House Ways and Means Chairman Camp's Tax Reform Act of 2014,[2] and ultimately passed into law as part of the TCJA.

According to the *Final Report* (Executive Summary):

> UBI must be generated by a "trade or business." An activity qualifies as a "trade or business" only if, among other things, the taxpayer engaged in the activity intending to make a profit. A pattern of recurring losses indicates a lack of profit motive. The IRS disallowed reporting of activities for which the taxpayer failed to show a profit motive. Those losses no longer offset profits from other activities in the current year or in future years, with more than $150 million of NOLs disallowed.

Since the publication of the *Final Report*, it has been the experience of our membership that IRS audit and examination practices in UBTI have increasingly considered profit motive (or the lack thereof), causing the IRS to disallow losses generated from activities that lack a profit motive. Thus, prior to passing statutory authority to "silo" unrelated activities, the IRS exercised its authority to oversee potential abuse without the need for an alternative, costly, and administratively burdensome solution.

<u>Recommendation</u>

The AICPA recommends that the IRS and Treasury issue proposed regulations providing for a *de minimis* exception to section 512(a)(6) for exempt organizations reporting less than $100,000 of gross UBI.

<u>Analysis</u>

Section 512(a)(6) makes no exception for small tax-exempt organizations with inadequate resources for maintaining separate detailed records for each trade or business. Accordingly, the requirement places a disproportionate administrative burden on smaller tax-exempt organizations.

A *de minimis* exception under section 512(a)(6) for organizations that report a small amount of gross UBI (less than $100,000) would reduce the administrative burden and related costs created by the need to track UBI activities separately, for smaller organizations, with minimal impact on federal revenue.

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[2] Former House Ways and Means Committee Chairman Camp released several discussion drafts outlining proposals to reform the U.S. tax system between 2001 to 2013. The second discussion draft was formally introduced in the U.S. House of Representatives as the Tax Reform Act of 2014 (H.R. 1, 113th Congress) on December 10, 2014.

A review of IRS statistical data relating to returns with positive UBTI is helpful in defining a practical and fair *de minimis* exception. According to IRS statistics for the 2013 tax year, 5% of total UBIT was paid by organizations that reported gross UBI of under $100,000.[3]

Organizations with less than $100,000 of UBI are likely to lack the internal staff, the ability to engage outside accounting professionals, and the resources to properly implement software, accounting, and other changes necessary to comply with section 512(a)(6). For example, tax-exempt organizations would require upgraded general ledger software to track each trade or business in order to maintain the appropriate records for tax preparation at the end of the tax year. Small tax-exempt organizations' limited funds are better spent fulfilling their tax-exempt purpose than on record keeping upgrades.

A *de minimis* exception would not result in reduced IRS oversight. The IRS would retain the ability to monitor organizations that utilize the *de minimis* exception via the audit or examination process (utilizing the "profit motive" concept) without those organizations having to engage in the detailed reporting likely required for section 512(a)(6) compliance.

II. Separate Trades or Businesses

Background

Exempt organizations are required to separately calculate the UBTI for each trade or business subject to UBIT under new section 512(a)(6). However, the TCJA did not provide rules for determining whether an exempt organization has more than one unrelated trade or business.

The Notice indicates that forthcoming proposed regulations will provide exempt organizations with the necessary guidance to make those determinations and requests assistance on analyzing possible methods that exempt organizations can use to identify separate trades or businesses for purposes of section 512(a)(6).

1. Use of Other Code Sections

Overview

The term "trade or business" is utilized multiple times in the Internal Revenue Code (IRC or "Code") and regulations. A separate business is one in which books and records are separable, but this has not been defined in the regulations. The issue of whether an activity rises to the level of a trade or business depends on which Code section is applied. The Notice requests feedback on whether other Code sections could help exempt organizations identify separate trades or businesses for purposes of section 512(a)(6).

[3] IRS, *"SOI Tax Stats – Exempt Organizations' Unrelated Business Inocme (UBI) Tax Statistics,"* Classed by: Type of Entity and Size of Gross UBI, Tax Year 2013, Table 4.

Recommendation

The AICPA recommends that Treasury and the IRS issue proposed regulations allowing exempt organizations to rely on section 446 and the regulations thereunder for assistance in the identification of a separate trade or business. However, permitting use of the section 446 rules should not exclude the use of other reasonable methods of determining the existence of a separate trade or business.

Analysis

The Notice suggests that specific Code sections, including section 132 (certain fringe benefits), section 162 (trade or business expenses), section 183 (activities not engaged for profit), section 414 (employment definitional rules), and section 469 (passive activity losses) could assist exempt organizations in identifying a separate trade or business for purposes of section 512(a)(6). However, these Code sections do not individually provide a framework for defining a trade or business. They provide exclusionary definitions of "what is not a trade or business" or "what is or is not allowed as a deductible expense" when conducting an activity already defined elsewhere as a trade or business.

The section 446 rules could help exempt organizations identify what is a separate trade or businesses for purposes of section 512(a)(6). Under section 446 and its regulations, taxpayers are permitted to claim they have more than one trade or business provided: (1) the method used for each trade or business clearly reflects the income of that particular trade or business; (2) the taxpayer maintains separable books and records for each trade or business; and (3) the maintenance of different methods does not create or shift profits or losses between the trades or businesses. As such, the regulations promulgated under section 446 provide a helpful framework for determining when a taxpayer is engaged in more than one trade or business.

However, permitting use of the section 446 rules should not preclude the use of other methods of determining the existence of a separate trade or business. For example, an organization that does not keep separate books and records may have a separate trade or business using other criteria, such as the fragmentation rules found in IRC section 513(c). Similarly, the existence of separate books and records for an activity does not necessarily define the activity as a separate trade or business. The determination that a taxpayer is engaged in multiple trades or businesses is primarily a factual determination.

The AICPA encourages Treasury to take a broad view and allow taxpayers of different sizes and complexity to utilize the method which best fits their facts and circumstances and provides the least administrative burden.

2. NAICS Codes

Overview

The Notice indicates that the IRS and Treasury are considering the use of the North American Industry Classification System (NAICS) 6-digit codes to help organizations determine separate trades or businesses. The NAICS codes are a standard used by Federal agencies to classify businesses for statistical purposes and may help exempt organizations group UBI activities to determine separate activities for section 512(a)(6) purposes.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations allowing taxpayers to utilize NAICS codes as a safe-harbor to separate and classify unrelated trades or businesses. If a taxpayer uses NAICS codes, IRS and Treasury should allow taxpayers to use the highest level of aggregation (i.e., the use of fewer than 6 digits) that reasonably defines a given trade or business for section 512(a)(6) purposes.

Analysis

Using NAICS codes is a logical safe harbor method for separating and classifying unrelated trades or businesses. It would provide tax-exempt organizations with a method for aggregating an organization's geographically dispersed trade or business activities into a single trade or business activity (e.g., a hospital system that operates five separate rural hospital facilities within a single entity, where each hospital's pharmacy sells pharmaceutical supplies to the public). The utilization of NAICS codes could allow, for example, an exempt hospital to program a specific NAICS code into its computer system to gather and report non-patient pharmacy sales as a single trade or business activity.

A requirement to define a business to the sixth NAICS digit level, however, could cause an unnecessary division of similar activities into multiple fragments. Where appropriate, we recommend allowing exempt organizations to use shorter, more general NAICS codes for activity aggregation. For example, a hospital could utilize a NAICS code of either 3 or 4 digits to aggregate non-patient care under section 512(a)(6) (either the NAICS 3-digit code 622, "Hospitals" or the NAICS 4-digit code 6221, "General Medical and Surgical Hospitals").

The following example illustrates how unique facts and circumstances could lead exempt organizations to arrive at different reasonable reporting positions under section 512(a)(6), utilizing appropriate NAICS codes of varying lengths.

> *Example 1*
>
> Hospital 1 is operated in a rural area away from the center of town. There is an abundance of free parking around the facility, including neighborhood parking and a paved parking lot. There is a pharmacy in the hospital from which patients can pick up prescriptions as they check out of the hospital.
>
> There is no direct access to the pharmacy from outside of the hospital. However, non-patients (such as hospital workers or neighbors) can access the pharmacy by visiting the hospital, dropping off a prescription, providing their insurance information, and paying any co-pay amount. The pharmacy is equipped to accept and track non-patient pharmacy sales.

The pharmacy area also includes a gift shop which sells convenience items to family members and other individuals visiting patients. These items are tracked as retail sales, and gross profit margins are slim. All gift shop inventory items are purchased with the expectation of being sold for the convenience of patient visitors or employees.
The hospital also provides laboratory services to neighboring doctor clinics and the local veterinary hospital. There are no other local laboratory services readily available; the hospital is not competing with outside businesses.

Total gross revenues from all non-patient ancillary services associated with operating the hospital are less than $4,000,000, and net non-patient activity typically ranges from a $50,000 net loss to $150,000 in net income. The hospital allocates direct expenses. It does not allocate indirect expenses to the individual activities (since it allocates an aggregate indirect rate to all unrelated non-patient revenue).

The unrelated ancillary activities (parking, pharmacy, gift shop, laboratory) of Hospital 1 are centered on the provision of health care (albeit to non-patients). Therefore, it is reasonable to classify these activities as one overall activity ("health care") rather than splitting them into separate activities. In addition, the gift shop activity is excludable from UBIT because it meets the "convenience" exception. Accordingly, a 3-digit NAICS classification of 622, or a 4-digit classification of 6221 is appropriate for this hospital since all unrelated ancillary activates are reasonably reportable under this activity code.

Example 2

Hospital 2 is a large hospital operating in a downtown area. The hospital owns several multi-level parking garages where patients can park. Patients can (but are not required to) pay for parking within the hospital facility. The parking garages are also utilized by the public. The revenue from the parking garages is tracked by payment at the outside kiosks or at the gate, where the customers are asked if they are a patient or visitor of the hospital.

The hospital has a pharmacy where patients can pick up prescriptions as they check out of the hospital. There is access to the pharmacy from outside of the hospital via a drive-through window. Non-patient pharmacy use is encouraged and advertised in the local area newspaper. The pharmacy stocks regular inventory similar to items offered by other neighborhood drugstores. The hospital also provides laboratory services for the neighboring doctor clinics and competes with other local laboratory companies. It also provides commercially available specialty lab tests such as deoxyribonucleic acid (DNA) genetic testing.

There are several cafeterias and coffee shops inside the hospital. Some of the cafeterias and coffee shops are accessible only from within the hospital, while other shops are accessible both from inside and outside of the hospital. There is also a restaurant at the top of the hospital with a view of the city. Reservations for the restaurant are available.

Total gross revenues from each separate non-patient ancillary service is greater than $1,000,000, with ranges between $500,000 net loss and $500,000 net income. The hospital allocates direct expenses and has an indirect cost rate for allocating overhead expenses to each ancillary activity.

Because the unrelated ancillary activities of Hospital 2 include the provision of both non-patient health care services and other non-patient unrelated services that are only tangentially related to health care, use by Hospital 2 of a top-level NAICS "hospital" code of 622 or 6221 for all unrelated activities is arguably too broad. However, the following NAICS codes are reasonable:

- NAICS Code 6221 (General Medical and Surgical Hospitals) – pharmacy and lab services;
  - A further breakdown of these two activities into "pharmacy" and "laboratory" services is possible if such classification is more reasonable:
    - NAICS Code 446110 (Pharmacies and drug stores)
    - NAICS Code 621511 (Medical laboratories)
- NAICS Code 821930 (Parking lots, garages, services) – operation of parking facilities;
- NAICS Code 722514 (Cafeterias, grill buffets, and buffets) – operation of cafeterias and coffee shops.

3. Use of Any Reasonable Method

Recommendation

The AICPA encourages the IRS and Treasury to issue proposed regulations allowing taxpayers of different sizes and complexity to utilize any reasonable method of identifying separate trades and businesses provided the method is consistently used.

Analysis

It is beneficial to allow tax-exempt organizations to use other Code sections (such as section 446) to identify separate trades or businesses. However, permitting the use of the section 446 rules should not exclude the use of other methods of determining the existence of a separate trade or business. For example, an organization that does not keep separate books and records may have a separate trade or business using other criteria, such as the fragmentation rules found in section 513(c).

Additionally, we encourage the IRS to allow NAICS codes as a safe harbor method for separating and classifying unrelated trades or businesses. However, the IRS should not mandate the use of NAICS codes. It is important to allow taxpayers to self-define a trade or business as any regularly carried on commercial activity, either a stand-alone activity or an exploitative activity, for which (a) there are identifiable sources of revenues and expenses, (b) the activity does not substantially further the organization's exempt purpose, and (c) the activity does not easily lend itself to the classification codes as defined by the NAICS codes. Although the exempt organization may identify separate revenue streams, these separate revenue streams do not necessarily indicate separate trades or businesses. We also suggest that the proposed regulations provide that exempt organizations must allocate only those indirect expenses that directly relate to a given activity.

Organizations must use the method of accounting by which they keep their books and records. In terms of choosing a method for expense allocation, a tax-exempt organization should use the general standard of "reasonable and necessary" and consistently follow the same method from year to year. The selected method should not result in the double-counting of any expenses.

Examples of indirect expenses include:

- Facility costs (rent, mortgage interest, insurance, taxes, security, and utilities);
- Personnel costs (salary, benefits, and taxes);
- Information technology costs (software, computer services, software licenses and internet); and
- Office expenses (supplies, printing, postage, and subscriptions).

When allocating expenses across more than one unrelated activity, taxpayers should consistently follow one methodology for every activity. For example, if certain costs are allocated based on square footage for one unrelated activity, the taxpayer should use square footage to allocate those costs across all unrelated activities to avoid double-counting.

Commonly used methods for allocating indirect expenses include:

- *Fixed Cost* – Commonly used with expenses such as depreciation and labor; based upon utilization measured in hours or square footage;
- *Proportional Allocation* – Allocates 100% of a regular re-occurring expense, such as a utility bill, based upon a pre-determined use allocation percentage that is revisited and adjusted periodically;
- *Activity Based* – Requires collecting indirect costs and allocating among the activities utilizing the shared resources charged to activity performed, such as credit card charges or service requests;
- *Cost Rate Allocation* – Allocates shared indirect costs based upon a percentage of direct costs to total costs. For example, Program A has direct costs of $3,000, Program B has direct costs of $2,000 and UBI Activity C has direct costs of $1,000. The shared indirect allocation is 50%, 33% and 17% for A, B, and C, respectively.

In determining whether an indirect expense is allocable, the organization should consider whether the expense would have been incurred if the unrelated trade or business activity were the organization's sole activity. For example, an organization operating an unrelated business may incur tax preparation fees, but not security-related expenses. In cases where the expense is not incurred, no allocation is made. This methodology only applies to the allocation of indirect expenses.

Example (Organization that may have more than one indirect cost pool to allocate)

A college has several dual-use assets. The primary use for each asset is in an exempt activity, with the surplus capacity used for exploitative unrelated business activities that each generate gross income greater than $1,000. The exploited use of each dual-use asset relies on several shared resources of the college, including a centralized laundry service, centralized security service, and shared information technology services, including a gigabit point-of-presence (Gigapop).[4] In addition, the exploited exempt activity relies upon each dual-use facility and its facility costs.

The four exploited business activities in this example are:

- Advertising sold in alumni publications;
- Event rentals in college-owned facilities;
- Hotel/housing facilities for unrelated parties; and
- Use of fitness center/golf course by unrelated parties.

First, direct expenses are applied to each activity. Next, the exempt organization determines what appropriate indirect costs to include in each activity's indirect cost allocation pool:

Shared Cost\UBI Activity	**Advertising**	**Event rental**	**Fitness**	**Hotel**
Laundry	No	Yes	Yes	Yes
Security	No	Yes	Yes	Yes
IT – Shared license	Yes	Yes	Yes	Yes
Depreciation	Yes	Yes	Yes	Yes

If an organization groups expenses by department (e.g., facility, information technology, etc.), and that department generally represents one that is applicable to the business activity as outlined above, it is reasonable for an organization to allocate the total expenses of the department rather than on an expense-by-expense basis.

Example

An exempt organization utilizing its building in an unrelated activity groups all expenses related to the building under the facility department. This department includes the cost of utilities, depreciation, insurance, janitorial services, and other facility-related costs. Assuming these expenses would have been incurred if the organization's sole activity was the unrelated activity, the organization can allocate a portion of its facility expenses to this unrelated business activity, rather than allocating a portion of each underlying expense account (e.g., insurance, janitorial, etc.).

[4] An access point to an internet collaboration between universities and partners in industry and government to develop advanced internet technology.

Although the new section 512(a)(6) adds an additional layer of complexity to cost allocation, the methodologies outlined in our letters submitted on June 27, 2016[5] and February 23, 2017[6] (related to UBI expense allocation for dual-use facilities) remains valid for the allocation of indirect expenses between separate unrelated trades or businesses.

III. Aggregation of Certain Investment Activities

1. Allow Investment Activities as One Trade or Business

Overview

Many tax-exempt organizations hold investment funds treated as partnerships for federal income tax purposes. In many cases, investment funds are part of multi-tier partnership structures, often referred to as "fund of funds" arrangements. If an exempt organization is invested in a partnership that conducts UBI activities, it is required by section 512(a)(6) to include in UBTI its share of gross partnership income since the UBI activities of a partnership are considered attributable to the partners.

The Notice provides an interim rule allowing organizations to aggregate, as one trade or business, their investments in certain partnership interests for purposes of implementing section 512(a)(6).

Recommendation

The AICPA supports the intention of the IRS and Treasury, as stated in Section 5.02 of the Notice, to issue proposed regulations treating an exempt organization's investment activities as a single trade or business for purposes of section 512(a)(6). Furthermore, the proposed regulations should allow organizations to include in its investment activities the investment income from partnership interests.

Analysis

We applaud the IRS and Treasury for providing an interim rule in the Notice treating certain investment activities of an exempt organization as one trade or business. We urge the IRS and Treasury to include a provision in the proposed regulations that allows for the continued aggregation of investment activities.

Most exempt organizations consider their investment portfolio collectively and manage their investment portfolio under the umbrella of a single investment policy. The policy may include language on investment diversification meant to manage the risk level of the investments. As such, the exempt organization may, in an effort to diversify its investment portfolio, purchase a partnership interest that generates UBTI.

[5] AICPA letter, "*Unrelated Business Income Expense Allocation Methodologies for Dual Use Facilities*," June 27, 2016.

[6] AICPA letter, "*Unrelated Business Income Expense Allocation Methodologies for Dual Use Facilities*," February 23, 2017.

If proposed regulations do not include a provision allowing exempt organizations to aggregate their investment interests, they will incur a significant administrative burden in order to report the information separately. For example, the exempt organization would need to identify the income attributable to each trade or business of the partnership(s) reflected in the investment income reported on Schedule K-1. This requirement is particularly challenging when the exempt organization has investments in multi-tiered partnership structures since it would receive a Schedule K-1 from the top-tier partnership only.

In these types of structures, tax-exempt organizations are typically limited partners and generally have no knowledge of the activities of the lower-tier partnerships in which the fund invests. As a result, the exempt organization must rely on the investment fund to provide the necessary level of detail on the tax-exempt investor's Schedule K-1 in order for the exempt organization to comply with the requirements of section 512(a)(6). For example, the UBI separate trade or business reporting required to comply with section 512(a)(6) is more extensive than the passive activity reporting disclosures required by partnerships. The ability of an upper-tier partnership to report multiple trades or businesses is dependent in part on the information provided by the lower-tier partnerships.

If the exempt organizations were required to report the information separately, the increased reporting burden would result in the partnership incurring additional administrative costs that it would pass to the exempt organization in the form of additional fees charged by the funds. Alternatively, the fund may stop admitting exempt organization investors that rely on investments to generate funding. An increased administrative burden would also be placed on the IRS if separate reporting of investment activities from partnership interests was required since they would be tasked with auditing Forms 990-T for organizations owning interests in investment partnerships.

Treating investment activities as a single trade or business for purposes of section 512(a)(6) will reduce the administrative burden on organizations complying with section 512(a)(6) and on the IRS in enforcing the statute.

In addition, we suggest that proposed regulations allow for the flow-through of investment income from partnership interests to be included in the organization's investment activities.

2. Aggregation of Certain Qualifying Partnership Interests – Interim Rule

Background

Until proposed regulations are issued, Section 6.02 of the Notice provides an interim rule allowing exempt organizations to aggregate partnership interests that meet the definition of qualified partnership interests (QPI).

Recommendations

We recommend that the proposed regulations permit the aggregation of all investment activities as a single trade or business activity. However, if the proposed regulations do not permit the aggregation of all investment activities as a single trade or business activity, we recommend that they allow for continued aggregation of QPIs.

Analysis

The proposed regulations should make the interim rule permanent because it will lessen the administrative burden on practitioners, organizations and partnerships since they will not be required to track each trade or business within the partnership or provide separate UBIT reporting for each activity.

i. Potential Alignment of Qualified Partnership Interest Tests with Other Provisions in the Code

Overview

The interim rule in the Notice is similar to section 4943 excess business holding rules applicable to private foundations and certain supporting organizations. However, there are certain differences in how the rules would apply in terms of section 512(a)(6) versus how they are applied in the context of excess business holdings. These differences will cause confusion among tax preparers as well as the organizational employees and volunteers compiling the information for the Form 990-T related to section 512(a)(6), which could result in errors in completing the return. The QPI tests could become more administrable to all exempt organizations if more closely aligned with section 4943 in certain areas.

The legislative intent of section 4943 is to prevent private interests (e.g., private foundations and certain supporting organizations) from holding and operating significant family businesses under the guise of a charitable organization. Public charities, due to their broader support and governance, are not subject to the same business ownership limitations.

Recommendations

We recommend that Treasury and the IRS issue proposed regulations that align the QPI tests (*de minimis* and control) with other provisions in the Code and regulations, such as section 4943 related to excess business holdings as follows:

- Adopt the section 4943(d)(3) definition of a business enterprise which would allow any partnership investment that is considered 95% passive to automatically become a QPI regardless of the ownership percentage;
- Follow the section 4943(c)(2)(C) 2% *de minimis* rule,[7] which would allow an exempt organization (without regard to related organizations) that owns up to 2% of a business enterprise to automatically become a QPI;

[7] Per section 4943(c)(2)(C), a private foundation should not be treated as having excess business holdings in any corporation in which it (together with all other private foundations which are described in section 4946(a)(1)(H)) does not own more than 2% of the voting stock and not more than 2% in value of all outstanding shares of all classes of stock.

- Align the control test percentages of section 512(a)(6) with those of section 4943(c)(2)(B), which would increase the combined ownership with related interests from 20% to 35%; and
- Provide that the definition of "disqualified person" for QPI purposes references section 4946 instead of section 4958.

If the QPI provisions are not more closely aligned with section 4943, we suggest increasing the *de minimis* test threshold from 2% to 10% and the control test from 20% to 50%, thus creating an expanded definition of what constitutes a QPI.

Analysis

Alignment of the QPI rules with another existing Code section allows for ease of compliance and enforcement by all parties. Section 4943 is well-established law with numerous rulings, continuing education materials, and existing guidance. If the proposed regulations provide for full alignment (as opposed to the partial alignment as provided for in the Notice) with section 4943, confusion in applying the rules will be minimized and provide for greater consistency and accuracy when filing Form 990-T.

Additionally, full alignment with section 4943, including the definition of a business enterprise in section 4943(d)(3), will provide for broadening of the investment activity category as the majority of holdings by exempt organizations are generally below the 35% threshold or are 95% passive. The number of separate investment partnerships that will fall outside the thresholds will be minimal, which will allow for consistency and accuracy in complying with the requirements. It will also ease the IRS's burden of enforcing the rules.

Full alignment with section 4943 would allow 95% passive investments to be automatically considered QPIs because section 4943(d)(3)(B) excludes from the definition of a business enterprise "any trade or business at least 95 percent of the gross income of which is derived from passive sources."[8] Generally, these income sources are commonly considered passive investment income and not a trade or business. These investments should not be subject to UBI siloing provisions under section 512(a)(6).

The *de minimis* test outlined in Section 6.02 of the Notice combines related interests to determine the 2% ownership threshold. The excess business holding rules in section 4943 allow a private foundation to disregard the holdings of disqualified persons and commonly controlled private foundations if the foundation's ownership interest is 2% or less. Thus, it is reasonable for the *de minimis* test to act as a safe harbor for organizations and not combine its holdings with interests of disqualified persons or related interests.

If the interim rule is aligned with section 4943, a modification of the definition of "disqualified person" will be necessary. Section 6.02(2)(b)(ii) of the Notice defines "disqualified person" utilizing the rules of section 4958(f). However, the definition of "disqualified person" for QPI purposes should reference section 4946 instead of section 4958.

[8] Passive sources include interest, dividends, rent from real property and gains from sales of investments as per section 512(b)(1), (2), (3), and (5).

The QPI control test outlined in Section 6.03 of the Notice includes the following two elements:

- The organization (along with related interests) holds no more than 20% of a capital interest; and
- Does not have control or influence over the partnership.

The ownership threshold limit of 20% appears unreasonably low when combined with related interests. If the organization is a limited partnership, by definition, it does not have control or influence over the investment partnership. This situation warrants a higher threshold. For example, section 4943 allows for a 35% combined interest with disqualified persons when a third party has effective control over the enterprise.

Some commentators on Notice 2018-67 have recommended that the *de minimis* threshold should increase from 2% to 10%. While we welcome the expansion of the *de minimis* test, simply increasing the threshold will not decrease the burden to many organizations. However, if the threshold is increased to 10% and organizations need not include the related interests in the *de minimis* test threshold, the result would alleviate the administrative burden. If a private foundation fails both the *de minimis* and control tests with regard to its interest in a business enterprise, it will likely have excess business holdings with greater excise tax consequences than additional tax on UBI resulting from disaggregation. If aligned with the ownership percentages of section 4943, the interim rule could appear as redundant for private foundations and overly restrictive to other exempt organizations.

ii. Reasonable Efforts Standard

<u>Overview</u>

For organizations with a large board of directors, it is challenging to obtain the necessary information from all related interests to determine if a partnership investment is a QPI.

<u>Recommendation</u>

We recommend that the IRS and Treasury issue proposed regulations that include a reasonable efforts standard (similar to the standard included in the Form 990 and Form 990, Schedule L, *Transactions with Interested Persons*, instructions) in order for organizations to determine if they meet the ownership thresholds with related parties.

<u>Analysis</u>

There are many organizations with numerous investments in entities classified as partnerships for tax reporting purposes. It is difficult for these organizations to identify common ownership information from all related parties. For many organizations, the board of directors is large, and it is unreasonable for them to verify the ownership percentages for each partnership holding that generates UBTI. The organization often cannot obtain a list of investors and related ownership percentages from the partnerships in which the board members are invested. They must ascertain the information by asking their related parties.

A reasonable efforts standard, similar to the one included in the Form 990 and Form 990, Schedule L instructions, is needed for proper implementation of QPI tests. For example, a reasonable effort could include the distribution of an annual survey to related parties to determine if they hold an interest in these partnerships. With the use of an annual survey, however, we suggest not mandating a response from every party. The incremental information obtained would not justify the administrative burden.

iii. Continued Use of Reasonable Method to Apply Provisions

Overview

According to the interim rule in the Notice, an exempt organization may aggregate its UBTI from its interest in a single partnership with multiple trades or businesses, including trades or businesses conducted by lower-tier partnerships, as long as the directly-held interest in the partnership is a QPI (meets the requirements of either the *de minimis* test or the control test). The exempt organization can also aggregate all of its QPIs and treat them as a single trade or business for purposes of section 512(a)(6)(A).

To determine if an organization has met the requirements of the *de minimis* and control tests, it must have access to the partner's share of profit, loss and capital interests in the partnership. The Notice states that an exempt organization may rely on the Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, received from the partnership for this information. While reporting of a partner's share of profit, loss and capital is required in Part II, Line J of Schedule K-1, the information is occasionally not reported on the Schedule K-1. For example, some Schedules K-1 list "various" as the partner's ownership percentage.

Another concern regarding the *de minimis* test is that the calculation of the average ownership interest over the course of the year can create unintended or inaccurate results.

Recommendation

We recommend that the IRS and Treasury provide guidance on how an exempt organization should determine its ownership in a partnership for purposes of the *de minimis* and control tests in situations where the information related to a partner's share of profit, loss and capital interests are not reported on Schedule K-1.

We suggest allowing taxpayers to use an alternative reasonable method if the average ownership interest method used in the calculation of the *de minimis* rule creates unintended or inaccurate results.

Analysis

The partnership rules under subchapter K and the disclosures for Schedule K-1 are complex. For preparers of partnership returns, especially tiered partnerships, providing the relevant tax disclosures for the ultimate taxpayer is challenging. There are instances in which taxpayers cannot obtain certain required information from the partnership. For example, the profits or capital interests on Schedule K-1, although required to be reported, are not always provided. In these instances, we suggest allowing an exempt organization to use a reasonable method to determine the information provided it is consistently applied.

We appreciate the effort of the IRS and Treasury to allow organizations to aggregate the UBTI of QPIs. However, unintended results may occur when using the average ownership interest calculation in the *de minimis* rule, as illustrated in the following examples.

> <u>*Example #1*</u>
>
> Board Member owns 40% of a partnership. During the year, Board Member gifts the following ownership interests in the partnership to three unrelated charities:
>
> - June 1: An 18% ownership interest in the partnership to Charity A and 10% interest to Charity B.
> - September 1: a 2% ownership interest to another unrelated charity, Charity C.
>
> These gifts result in Board Member owning 12% of the partnership on June 2 (40% - 18% - 10% = 12%). After the additional gift on September 1, Board Member owned 10% of the partnership (12% - 2% = 10%).
>
> For purposes of the average calculation method in the Notice, Board Member's ownership interest in the partnership is 25% for the year (40% + 10% = 50%; 50% / 2 = 25%).
>
> Board Member is on the board of Charity C but not Charity A or Charity B. Charity C has a 2% interest in the partnership, which it acquired when Board Member's ownership was 12%. However, using the average calculation method for the control test, Charity C has a 26% ownership in the partnership (25% average from Board Member and 1% average from its own direct holding).

Under this example, Charity C does not meet the control test rule even though its actual ownership interests (directly and when combined with Board Member) did not exceed the 2% or 20% thresholds during the year. Inaccurate results occur in this scenario because of the requirement to average Board Member's beginning of year interest rather than the ownership interest immediately prior to the gift to Charity C.

We suggest allowing taxpayers to use a reasonable alternative reasonable method if the average ownership interest method used in the calculation of the *de minimis* rule creates unintended or inaccurate results. An organization should adopt any method it deems as reasonable if it yields an accurate economic result for the year.

The average ownership interest calculation also produces unintended consequences where an organization acquires ownership in a newly formed entity. See the following example for an illustration.

Example #2

In Year 1, Organization A purchased a 1% profits and capital interest in a newly formed domestic limited partnership and contributed the agreed amount in exchange for its partnership interest. Organization A did not control the partnership at any time during the year. As of the end of Year 1, only a few partners had made their required capital contribution to the partnership. However, the partnership began business operations. As a result, Organization A's profits and capital percentage at the end of Year 1 was 25%, which is above the limits outlined in both the *de minimis* and control tests.
As of the end of Year 2, the remaining partners had contributed to the partnership. Organization A's profit and capital interest at the end of Year 2 was 1%, as originally anticipated.

If the beginning and ending partnership interests are averaged, as outlined in Section 6.02(2)(a) of the Notice, Organization A's interest in Year 1 is considered a separate business activity since it does not meet the *de minimis* or control tests. In Year 2, it meets the control test but is still above the *de minimis* threshold. In Year 3 and forward (assuming no ownership changes), Organization A meets both the *de minimis* and control tests.

Under this example, guidance is needed in the following areas:

- Whether the partnership will indefinitely remain a separate trade or business based on the initial year determination;
- Whether it is allowable to combine the partnership with other qualified partnership interests in Year 2 when Organization A meets the control test and in Year 3 and onward when it meets both the control and *de minimis* tests; and
- Whether any loss from Year 1 must remain in a separate silo as the partnership interest did not meet the *de minimis* or control tests during that year or whether the losses follow the limited partnership into a different trade or business silo in Years 2 and 3.

3. Unrelated Debt-Financed Income

Overview

Per Section 6.05 of the Notice, a tax-exempt organization may aggregate, under the interim rule, income generated within a QPI that is unrelated debt-financed income (UDFI) within the meaning of section 514. Also, UDFI within a hedge fund may be aggregated with other UBTI generated by the hedge fund, if the hedge fund is a QPI. However, the Notice does not address how UDFI generated through a non-QPI or an activity conducted directly by the exempt organization should be aggregated with other UBI activities.

Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations that permit the aggregation of income and losses in certain circumstances involving UDFI. Specifically, we offer the following recommendations:

- Permit the aggregation of (1) non-QPI income that is UBTI because it is considered UDFI under section 512(b)(4) and (2) other income that is considered UBTI per section 512(b)(4), (13) and (17); and
- Permit the aggregation of non-QPI income and losses that is UBTI because it is UDFI held, directly or indirectly, with the exempt organization's other UDFI investment activity.

Analysis

With the exception of the modifications noted previously, we agree with the IRS and Treasury's intent (as indicated in Section 6.05 of the Notice) to allow for the aggregation of income, including UDFI, generated through QPIs. This approach is consistent with the statute and is administrable from the perspective of the IRS and the taxpayer. Furthermore, we suggest allowing the aggregation of UDFI from investment activities outside a QPI.

Section 512(b)(4) provides that:

> "Notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2)." Therefore, income from interest, dividends, rents, royalties or the gain or loss on the sale of property (other than inventory or property held for sale to customers in the ordinary course of the trade or business), excluded from UBTI by the provisions or section 512(b) (1), (2), (3), or (5), is UBI if considered "debt-financed property" under section 514.

Section 4 of the Notice states:

> "The Treasury Department and the IRS note that, in the absence of § 512(b)(1), (2), (3), and (5), interest, royalties, rents, and gains (or losses) from the sale, exchange, or other disposition of property would be included in the calculation of UBTI to the extent such amounts are "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it" under § 512(a)(1). Accordingly, the Treasury Department and the IRS **see no distinction** between "gross income derived by any organization from any unrelated trade or business … regularly carried on by it" within the meaning of § 512(a)(1) and amounts included in UBTI "as an item of gross income derived from an unrelated trade or business" under § 512(b)(4), (13), and (17)."

We disagree with the Notice and believe there is a distinction between amounts that are UBTI under sections 512(b)(4), (13), and (17), and amounts that are derived from an unrelated trade or business regularly carried on by an organization. Otherwise, except for section 512(b)(4), all investment activities would be considered an unrelated trade or business.

Even if there was no distinction, income and loss from activities considered UBTI due to the operation of sections 512(b)(4), (13), and (17), should be allowed to be aggregated.

We suggest that the proposed regulations allow for the aggregation of all non-QPI investment activities into one trade or business for purposes of section 512(a)(6)(A). The *de minimis* and control test modifications for QPI generated UBI suggested above distinguish investment activities from situations where the exempt organization is actively engaged in an unrelated activity. We also suggest applying a similar approach to UDFI.

For example, if an exempt organization owns a building with ten floors and rents out two floors to an unrelated organization, the rental income is not considered UBI unless there is debt associated with the building. The rental income excluded under section 512(b)(3) is UBI under section 512(b)(4). Whether or not there is debt on the building does not change the passive nature of the income to the exempt organization. The income is more akin to investment income than income from an active trade or business. The incurrence of debt does not create trade or business income out of interest and dividend income under section 162. The amounts are investment income with related investment interest expense. Therefore, we recommend allowing the aggregation of net losses generated from an activity by an exempt organization that has UBTI because it is UDFI with other investment UBTI (including non-QPI pass-through investments).

IV. Net Operating Losses

Overview

A net operating loss (NOL) generally means the amount by which a taxpayer's business deductions exceed its gross income.[9] Different carryback periods apply with respect to NOLs arising in different circumstances. In general, NOLs arising in taxable years beginning before January 1, 2018, may offset up to 100% of taxable income and be carried back two taxable years and forward 20 taxable years. NOLs arising in taxable years beginning after December 31, 2017 may be carried over with no expiration period and used to offset 80% of taxable income. A taxpayer with NOL carryovers to a taxable year from both taxable years beginning before 2018 and taxable years beginning after 2017 need to perform additional analysis in order to address how to apply the losses going forward.

Section 512(a)(6) may change how an exempt organization with more than one unrelated trade or business calculates and takes NOLs into account for a particular trade or business. Section 512(a)(6) states that to the extent a separate trade or business has a loss, it is treated as an NOL.

An exempt organization will need to determine how NOLs are utilized going forward. The correct methodology is currently unclear (for example, siloby-silo calculation or combining entities, etc.).

[9] Section 172(c).

Computation of Combined Taxable income and NOL Allocation Limitations

Recommendation

We recommend that the IRS and Treasury issue proposed regulations similar to Treas. Reg. § 1502-11 for consolidated groups to provide guidance on how to compute the combined taxable income for the exempt organization, including how the limitations (e.g., charitable contribution deduction, capital gains and losses for UBI activities, section 1231 gains and losses from UBI activities and NOLs) computed on a combined basis are allocated back to each trade or business.

Analysis

The order in which an organization utilizes pre-2018 and post-2017 NOLs under section 512(a)(6) is unclear because of the requirement for the organization to calculate UBTI in each silo separately before calculating total UBTI. Therefore, section 512(a)(6) is arguably an ordering rule requiring post-2017 NOLs to be used before pre-2018 NOLs.

Once it is determined that a silo has an NOL, section 172, as it is applied to all taxpayers, should control the carryover and use of the NOL by an exempt organization. This approach is consistent with the intent of section 512(a)(7) to provide parity between exempt and non-exempt employers for the disallowance of qualified fringe benefits.

Currently, it appears an exempt organization must compute the combined taxable income or loss in several steps. First, the separate taxable income or loss of each silo is determined in accordance with the eliminations and adjustments specific to divisions within an organization (e.g., intercompany transactions, inventory, etc.). Next, items excluded from the computation of separate taxable income (e.g., charitable contribution deduction, capital gains and losses, combined NOL deduction, etc.) should be computed on a combined basis. The impact of the items excluded from the computation of separate taxable income in step one are allocated to each silo or non-trade or business income in some manner to be determined. The silos with net losses are limited to zero, and the combined taxable income is determined by adding the results obtained in the prior steps.

The requirement for exempt organizations with more than one unrelated trade or business to separately compute the income or loss of each trade or business impacts the computation of current year taxable income, the computation of an NOL for the current tax year, and the potential use of NOL carryforwards. Several Code sections may require the computation of an exempt organization's combined taxable income. Guidance is requested regarding how to compute taxable income and allocate such items computed at the combined level back to the separate silos.

If Congress had intended to limit post-2017 losses by silo in a manner similar to the law for publicly traded partnership passive losses, the statute would have been drafted similar to section 469. Under section 469(b), any losses or credits disallowed in the current year are carried over and are treated as deductions or credits allocated to the activity the following year. Section 469(k) provides that in determining the allowed use of passive losses from a publicly traded partnership, losses may only be used against income of the same publicly traded partnership and not against other passive activities (i.e., the losses are siloed). The carryover of disallowed items, not as NOLs but rather as a similar deduction, is also seen in the areas of investment interest expense (section 163(d)(2)), business interest (section 163(j)(2)), losses in excess of at-risk amounts (section 465(a)(2)), losses in excess of a partner's basis (section 704(d)(2)), and losses in excess of a shareholder's basis (section 1366(d)(2)).

Require Statements and Schedules for each Separate Line of Business

Recommendation

We recommend that the IRS and Treasury issue proposed regulations, similar to Treas. Reg. § 1502-75(j) for consolidated groups, requiring the attachment of statements and schedules for each separate line of business to the Form 990-T reporting gross income, deductions, and credits.

Analysis

Form 990-T currently requires a Schedule M for each trade or business. The exempt organizations should provide the applicable statements and schedules in a columnar format, combining information from all Schedules M. This columnar format would likely replace the need for the required Schedule M since a consolidated Form 1120 does not require the attachment of a Form 1120 (Page 1) for each member of the consolidated group.

The statements and schedules, as well as the columnar format, would summarize the details of the items of gross income, deductions, and credits for each trade or business and provide overall simplification for audit purposes.

Allow Election on a LIFO or FIFO Basis

Recommendation

We recommend that the IRS and Treasury provide proposed regulations to allow exempt organizations with more than one trade or business to elect to utilize NOLs for the current and future tax years either on a last in, first out (LIFO) or first in, first out (FIFO) basis in the first tax year that there is a Form 990-T filing requirement. If no election is included with the return, the taxpayer is deemed to have elected FIFO, the customary method under section 172.

Analysis

Allowing exempt organizations to elect to utilize LIFO or FIFO provides an alternative for calculating losses that is simpler for many taxpayers, but does not remove the more complicated option for those taxpayers that believe it is more beneficial. In addition, requiring taxpayers to utilize LIFO can be unfavorable in certain circumstances, as the most recent NOL incurred would be used first and historical NOLs forgone. For example, if the taxpayer has NOLs that are expiring in a year with taxable income, it is helpful to allow the historical NOL usage first to protect the NOL from expiring. The most recent NOLs would then carry forward to future tax years.

Alternatively, if no election is made with the return, the exempt organization is deemed to have elected FIFO as that is historically the default method used to apply NOLs against taxable income.

Allow Suspension of NOLs if a Trade or Business Activity Ceases

Recommendation

We recommend that the IRS and Treasury issue proposed regulations allowing for the suspension of post-2017 NOLs if one of the trade or business activities ceases. If the organization later restarts the same trade or business, it may use prior suspended NOLs for that trade or business.

Analysis

The tax policy for the carryover of NOLs are two-fold: (1) they allow losses incurred in start-up years to be used against income in later taxable years; (2) they tend to effectively tax the accumulated income of the entity. Sections 269 and 382 were enacted to prevent trafficking in NOLs upon purchase, recapitalization or reorganization of companies. An exempt organization has no owners; losses are not transferred from one taxpayer for use by another. The business continuity of an exempt organization is represented by all of its activites rather than the activities of each silo.

NOLs should not terminate automatically when one of the silos ceases or suspends a trade or business, as each silo is a separate division of the exempt organization. Prior incurred NOLs should be preserved and if the same trade or business is later restarted, the taxpayer should not lose access to the NOL. Termination of the NOL, rather than having the NOL suspended, provides a harsh result. Section 512(a)(6) is silent on the treatment of losses once the activity temporarily ceases. Allowing these losses upon resumption of the activity provides an equitable result and is in line with the tax policy of effectively subjecting the cumulative trade or business income of the entity to taxation. In addition, other entity types are allowed to suspend their NOLs. For example, section 501(c)(12) cooperatives suspend their "taxable year" NOLs (i.e., years in which they fail the 85% income test under section 501(c)(12)(A) and therefore file a corporate tax return) during those years in which they file a Form 990.[10] As section 512(a)(6) is silent on the current treatment and other entity classes are allowed NOL suspension, the IRS and Treasury should consider similar treatment when a silo ceases a trade or business.

[10] The 85% member income test is computed each tax year. If in any year the member income falls below 85% of the total income received that year, the organization is no longer exempt under section 501(c)(12) for that tax year and must file a corporate tax return. See Rev. Rul. 65-99, 1965-1 C.B. 242.