TEGE Exempt Organization Council
Comments in Response to Notice 2018-67

January 14, 2019

This document responds to the request for comments in Notice 2018-67 and reflects feedback from individuals participating in the TEGE Exempt Organizations Council (the "Council" or "TEGE Council").

The TEGE Council was formed to (i) open and maintain lines of communication between the Tax Exempt & Government Entities Division (the "Division") of the IRS and the practitioner community, (ii) provide the Division with the thinking of the practitioner community on procedural and systemic matters, (iii) provide practitioners a forum to share their concerns with the IRS regarding both policies and specific tax issues and procedures, (iv) educate the practitioner community and the exempt organizations community.

The Council's members and participants include attorneys, certified public accountants, and other practitioners and professionals in the exempt organizations community (including in-house practitioners and professionals). The comments below do not necessarily represent the views of the Internal Revenue Service (the "Service or "IRS"), Treasury, the TEGE Exempt Organizations Council, or any particular Council member. The preparers of these comments were not engaged by any client for the purpose of submitting these comments or otherwise to influence the development or outcome of regulatory guidance.

In Notice 2018-67, the IRS and Treasury requested comments regarding how to identify separate unrelated trades or businesses, for purposes of Section 512(a)(6) of the Internal Revenue Code ("IRC"). In particular, the Service and Treasury requested comments as to the following issues:

1. Where and how IRC Sections 132, 162, 183, 414, and 469, and the regulations thereunder, may aid in determining how to identify an exempt organization's separate trades or businesses for purposes of Section 512(a)(6);

2. Whether using fewer than 6 digits of the NAICS codes, or combining NAICS codes with other criteria, would appropriately identify separate trades or businesses for purposes of achieving the objective of Section 512(a)(6);

3. How to treat income that is not from a partnership or a regularly carried on trade or business, but that is included in unrelated business taxable income ("UBTI") under Sections 512(b)(4), (13), or (17), for purposes of Section 512(a)(6); and

4. The scope of activities, both investment partnership interests or other activities in the nature of an investment that may generate unrelated business income, that should be included in the category of "investment activities" for purposes of Section 512(a)(6).

We will address each of these areas in our comments.

I. Use of Criteria from Other Code Sections in Identifying Separate Trades or Businesses

In comments dated August 13, 2018, members of the TEGE Council proposed that exempt organizations should be able to identify separate trades or businesses, and group similar activities as a single trade or business, for purposes of Section 512(a)(6), based on a number of factors, including:

(i) Causal connection to UBTI—i.e., the degree to which the activity contributes importantly to the generation of the revenue or loss. Would the revenue or loss have occurred but for the activity?

(ii) Management structure—i.e., the extent of common control over the activity by the same persons pursuant to the same policies and procedures;

(iii) Geographic location where activities are carried out; and

(iv) Interdependencies between or among the activities, for example, the extent to which the activities:

  (a) involve the same products or services,

  (b) involve products or services that are customarily provided together,

  (c) are provided to the same customers,

  (d) are conducted by the same individuals,

  (e) involve common planning and coordination, or

  (f) are treated as a single unit or category for accounting and reporting purposes.

In articulating these factors, the TEGE Council members drew from analogous IRC sections (e.g., 183, 469) and related regulations that set forth factors taxpayers should use in grouping similar activities as a single trade or business activity, for purposes of those sections.[1]

For instance, Treas. Reg. §1.469-4(c) provides that one or more trade or business activities or rental activities may be treated as a single trade or business activity, for purposes of determining passive activity gains or losses, if they constitute an appropriate economic unit, depending upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in group activities. This regulation provides that the following factors are given the greatest weight in determining whether activities constitute an appropriate economic unit:

- Similarities and differences in types of trades or businesses

[1] See also Treas. Reg. §1.446-1(d), which articulates a general standard for identifying and accounting for separate trades or businesses, for accounting method purposes.

- The extent of common control
- The extent of common ownership
- Geographical location
- Interdependencies between or among the activities; for example, the extent to which the activities:
    - Purchase or sell goods between or among themselves
    - Involve products or services that are normally provided together
    - Have the same customers
    - Have the same employees
    - Are accounted for with a single set of books and records

Similarly, Treas. Reg. §1.183-1(d)(1) provides that multiple undertakings may constitute a single activity, for purposes of determining whether an activity is engaged in for profit, based on all facts and circumstances. Generally, the most significant facts and circumstances in making this determination are:

- The degree of organizational and economic interrelationship of various undertakings
- The business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business
- The similarity of various undertakings

Treas. Reg. §1.183-1(d)(1) notes that the Commissioner will generally accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case.

Sections 183 and 469, like Section 512(a)(6), limit the use of losses from one activity to offset gains from another activity or activities. The regulations under Sections 183 and 469 address the same issue raised by Section 512(a)(6): how to identify separate trade or business activities and group similar activities together into a single trade or business activity. The Section 183 and 469 regulations set forth general, administrable standards that at once establish guardrails for identifying trade or business activities and provide taxpayers with flexibility to reasonably group similar activities as a single trade or business within those guardrails. In adopting these regulations, the IRS and Treasury recognized that such a flexible standard has greater administrability and long-term viability than a narrower, more mechanical definition that would need to be amended from time to time to accommodate ever-evolving and expanding types of trade or business activity.

There is ample precedent for adopting general tax characterization standards within the UBTI realm. Numerous sections of the Code and regulations that govern unrelated trade or business activity require exempt organizations to apply general standards, using a facts and circumstances analysis, in characterizing different trade and business activities:

- Determining whether trades and businesses are substantially related or unrelated, for purposes of determining UBTI under Section 513(a);

- Determining whether and to what extent the use of debt-financed property substantially furthers tax-exempt purposes, to determine whether income from debt-financed property is UBTI under Section 514(b)(A)(A); and

- Determining whether more than an insubstantial amount of trade or business activity is unrelated, for purposes of determining tax exemption under Treas. Reg. §1.501(c)(3)-1(c)(1)

Although it can be challenging at times to make characterizations under these UBTI standards, the exempt community and the IRS have done so for decades, demonstrating that general UBTI standards are administrable for both the IRS and taxpayers.

Accordingly, rather than impose a narrow mechanical framework (e.g., NAICS codes) that inevitably will not accommodate all trades or businesses and will result in inconsistent and inaccurate characterization and reporting (as described in the following section of these comments), it would be more consistent with existing UBTI law and closely analogous sections of the Code and regulations (e.g., 183, 469) to set forth a general standard, using general criteria, for how to group similar activities into a single trade or business for purposes of Section 512(a)(6). This approach would provide needed flexibility for exempt organizations to make reasonable characterizations of the diverse and ever-expanding array of trade or business activities that they engage in. It would also enable organizations to group existing activities consistently with how they already group them for different accounting and reporting purposes.

To assist taxpayers in grouping similar activities into separate trades or businesses, we encourage the IRS and Treasury to include in Section 512(a)(6) regulations and/or other guidance the specific (or similar) examples set forth in the comments of the TEGE Council members on August 17, 2018. These examples could provide safe harbors for, and promote consistency in, organizations' grouping of similar activities into single trades or businesses, for purposes of Section 512(a)(6).

II. Use of NAICS Codes in Identifying Separate Trades or Businesses

A. NAICS Codes Do Not Reliably Identify Separate Trades or Businesses

In Notice 2018-67, Treasury and the IRS state that they "are considering the use of North American Industry Classification System ("NAICS") codes" in determining separate trades or businesses under Section 512(a)(6). The Notice indicates that, pending issuance of proposed regulations, Treasury and the IRS will consider the use of six-digit NAICS codes in determining whether an exempt organization has more than one separate trade or business to be a reasonable, good-faith interpretation of Section 512(a)(6). The Notice asks for comments regarding the utility of using NAICS codes, and whether using fewer than six digits of the NAICS codes, or combining NAICS codes with other criteria, would appropriately identify separate trades or businesses for purposes of Section 512(a)(6).

As described above, and in the August 17, 2018 comments submitted by TEGE Council members, it is essential for exempt organizations to have the option to utilize a more general standard rather than be required to use a more limited, mechanical framework such as NAICS codes for characterizing activities as unrelated trades or businesses under Section 512(a)(6). The use of NAICS codes may have utility in a facts and circumstances analysis under this general standard as a safe harbor for, and/or as a factor to be used in, characterizing separate, unrelated trades or businesses. However, they should not be adopted as the exclusive means to identify and classify separate trades or businesses, for the following reasons:

As the Notice indicates, exempt organizations already use NAICS codes to describe their activities on Form 990-T, though they do so for descriptive reporting purposes, not for purposes of making characterizations that affect their tax liability. Although the IRS uses NAICS codes (generally at the two-digit level) to report unrelated business income tax figures in its Statistics of Income series, the IRS has shown greater aversion to—rather than utilization of--codes to categorize exempt organizations' activities in recent years, having recognized their limitations. In particular, the IRS has eliminated reporting of activity codes on Form 1023. It has also changed course and not required filers to report National Taxonomy of Exempt Entity ("NTEE") codes on Form 990, Part III, because:

(1) The IRS didn't control the codes (the Urban Institute controlled them), and therefore lacked the flexibility to change these codes to further its purposes and meet its needs.

(2) NTEE codes were designed to identify purposes of organizations, not their specific activities.

(3) It is challenging to match a single NTEE code with an organization's primary activity. Because NTEE codes were designed by and for researchers, they make distinctions unrelated to tax purposes and fail to make distinctions relevant for tax purposes, while failing to identify specific activities of concern to the IRS.

Similarly, the IRS does not control NAICS codes, which were developed by the Office of Management and Budget and are maintained by the U.S. Census Bureau. The website of the U.S. Census Bureau (https://www.census.gov/eos/www/naics/faqs/faqs.html) explains that NAICS is designed to group businesses into industries according to similarities in the processes used to produce goods or services, and is used by Federal statistical agencies in classifying business establishments for the collection, tabulation, presentation, and analysis of statistical data describing the U.S. economy. Note that the codes were not designed, and are not maintained, for tax classification purposes.

Likewise, it is often challenging to match a single NAICS code to a particular unrelated trade or business. An activity may fit into different NAICS codes, depending on the type of transaction such as retail, rental or service income. While it would be reasonable to consider an activity as a single trade or business if it were operated in one location under one name, using the same staff, and same equipment, using the methodology of NAICS system could lead to different treatments.

Similarly, an exempt organization may bundle various services together in a single trade or business. Requiring the organization to un-package the bundle, for purposes of characterizing parts of that activity according to NAICS industry designations, would be administratively burdensome and would unfairly disadvantage exempt organizations in relation to for-profit organizations, which report the same bundled activity as a singular trade or business on their tax returns. The following examples illustrate this problem:

Example 1. A museum provides catering services, valet parking and personal property rentals for its special events clients, which include wedding parties, area businesses, etc. The museum has a special events manager who manages and oversees the special events. The special events manager coordinates staffing needs for the special events with internal departments as well as external vendors.

If required to use NAICS codes, the museum would need to look for four different NAICS codes to report the income as income from four trades or businesses: catering, parking, rental of real property, and personal property rentals. The museum would also have to unbundle all the package offerings to segregate income from each event; and would have to allocate personnel costs, depreciation, utilities, and other expenses against the bundled activities.

However, if allowed to use a more general standard and a facts and circumstances analysis, the museum could note the NAICS codes as one factor to consider in reporting the income from the special events activity. The museum could then consider other factors such as the interdependence and the common control of the activity by the same persons in determining that the special events activity is one trade or business. In this situation, it would be less of an administrative burden on the museum to track revenue and expenses from the special events activity as one trade or business, rather than having to treat the special events activity as four different trades or businesses for Form 990-T reporting purposes.

This would put the museum in an equivalent position for tax reporting purposes as its neighboring for-profit conference center that also provides the same bundled services to wedding parties and area businesses.

Example 2. In Example 1, if the museum were to provide its parking facilities to the public (outside of the special events activities at which it operates those facilities primarily for the convenience of museum patrons), the museum would again need to apply the general standard and analyze the facts and circumstances to determine how to report the parking revenue. In this scenario, the museum may very well provide parking in a different manner than it does during special events.

For example, the museum may lease its lot to a third party vendor in this example; no valet service may be offered; no security may be provided, etc. In this case, it may be appropriate for the museum to report the parking revenue separately from the parking revenue generated by the special events activity in determining Form 990-T reporting requirements.

Example 3. A nonprofit hospital operates a maternity store in the hospital that sells and rents medical equipment such as breast pumps or other medical equipment to both patients and non-patients. Although the hospital operates this store as a single trade or business, retail sales of this type could fall under NAICS code 4461 (Health and Personal Care Stores) or 4539 (Other Miscellaneous Store Retailers) within NAICS code 44-45 (Retail Trade), while the equipment rental could potentially fall under NAICS code 5322 (Consumer Goods Rental) within NAICS code 53 (Real Estate and Rental and Leasing).

Example 4. A nonprofit physician dermatology clinic provides spa services and sells personal care items (lotions, skin care products, etc.). In any given year the majority of sales to non-patients generating UBTI could be from either the spa services or retail sales. Although the clinic comprises a single trade or business, utilizing the NAICS methodology could lead to characterizing the clinic operations as two separate trades or business, possibly under NAICS code 8121 (Personal Care Services) within NAICS code 81 (Other Services) and 4461 (Health and Personal Care Stores) or 4539 (Other Miscellaneous Store Retailers) within NAICS code 44-45 (Retail Trade).

Although the examples above demonstrate how NAICS codes can be too particular to reflect an actual trade or business, some NAICS codes may be too broad to characterize a single trade or business, as they may describe more than one trade or business.[2] In those cases, exempt organizations may be incentivized to combine activities that they would normally treat as separate trades or businesses into a single trade or business, for purposes of limiting liability under Section 512(a)(6).

Attempting to fit a round peg trade or business into a square hole NAICS code, as in the examples above, would require a burdensome, fact-intensive analysis, and result in inconsistent characterization[3] and reporting by organizations that engage in similar trades or businesses that

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[2] The IRS acknowledges in prior year and draft 2018 Form 990-T instructions that most of the 6-digit NAICS codes describe more than one type of activity:

- **Business Activity Codes**

> "….Note that most codes describe more than one type of activity. Avoid using codes that describe the organization rather than the income-producing activity."

[3] The government has acknowledged inconsistencies in the classification of activities using NAICS codes. For instance, a recent Treasury Inspector General for Tax Administration (TIGTA) report determined that the NAICS codes are unreliable for use in identifying businesses that may be subject to excise tax reporting and payment. See TIGTA, Ref. No. 2014-43-043, *The Affordable Care Act: An Improved Strategy is Needed to Ensure Accurate Reporting and Payment of the Medical Device Excise Tax* (July 2014). In particular, TIGTA found that use of NAICS codes did not accurately identify businesses engaged in the sale of medical devices. It indicated in the report that 958 of 2,965 businesses that filed a Form 4720 to report the medical device excise tax classified that sales activity using

integrate multiple activities. Accordingly, it would be more administrable and less burdensome for exempt organizations to have the option to use the more general standard described above in identifying and reporting separate trades or businesses, for Section 512(a)(6) purposes.

B. Use of Two-Digit NAICS Codes Would Be More Administrable Than Use of Longer Codes

If Treasury and the IRS were to utilize NAICS codes to identify separate trades or businesses, for Section 512(a)(6) purposes, the two-digit NAICS codes would be more feasible to use than longer NAICS codes. As discussed above, while we do not recommend that NAICS codes be the exclusive means of identifying separate trades or businesses, the use of two-digit codes may be helpful as a safe harbor for smaller organizations or as a factor a larger organization may use to identify separate trades or businesses. We do not recommend the use of NAICS codes longer than two digits under any circumstances.

There are over 1,000 six-digit NAICS codes, and they are far too narrow to be used to define separate trades or businesses. As illustrated both in the examples above and below, use of these six-digit codes would cause inconsistent reporting of UBTI within the exempt organization community, increase tax risks unnecessarily, and possibly lead to perceived abuse.

One reason that NAICS codes with two digits would be preferable for delineating trades or businesses for Section 512(a)(6) purposes is that longer NAICS codes often reflect components of a single trade or business, but not the entire business. For instance, six-digit NAICS codes are intended to classify each physical location where business is conducted (for example, each factory, hotel, mine, or central administrative office) based on the "primary business activity" conducted at that location, often determined by revenue. Thus, a six-digit NAICS code assigned to a business location does not attempt to encompass all of the activities conducted at that location, even if all of those activities are conducted as single trade or business. This is evident from the following examples:

- The two-digit NAICS code 72 encompasses Accommodation and Food Services. The three-digit code 722 encompasses food services and drinking places. (The only other three-digit code under 72 is 721, which is for Accommodation.) The three-digit code 722 includes, among others: caterers (722320); mobile food services (722330); full-service restaurants (722511); limited-service restaurants (722513); cafeterias, grill buffets, and buffets (722514); and snack bars (722515). A single food service establishment at a cultural or educational institution might fall within all six of these categories at different times using the same kitchen and staff. If any of the food activities are unrelated to exempt purposes,

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code 339110 (Medical Equipment and Supplies Manufacturing), while 2,007 of those businesses used various other codes to identify the sale of medical devices, including 454390 (Other Direct Selling Establishments) and 423990 (Other Miscellaneous Durable Goods).

A prior TIGTA report on the excise tax on indoor tanning services also concluded that NAICS codes reported on tax returns for indoor tanning services activities were not consistent, and could not be relied upon as being correct. See TIGTA, Ref. No. 2011-40-115, *The Affordable Care Act: The Number of Taxpayers Filing Tanning Excise Tax Returns is Lower Than Expected* (Sept. 2011).

they should all be treated as the same trade or business. In this case, 722 is the largest code that could be used, while the two-digit code 72 would more accurately reflect the trade or business as a whole.

- The two-digit NAICS code 54, professional, scientific, and technical services, has only one three-digit code – 541 – also named professional, scientific, and technical services. However, 541 includes 49 distinct six-digit codes. Research, for example, is broken into: research and development in nanotechnology (541713); research and development in biotechnology, except nanobiotechnology (541714); research and development in the physical, engineering, and life sciences (except nanotechnology and biotechnology) (541715); and research and development in the social sciences and humanities (541720). Some or all of these might be conducted on an undifferentiated basis in an exempt organization's laboratory as a single unrelated trade or business.

In these examples, a six-digit NAICS code would not cover all similar activities performed by the same people using the same facilities. An establishment that was primarily a cafeteria (722514) could be classified as such regardless of its catering services without adverse consequences. A trade or business definition under Section 512(a)(6), on the other hand, needs to account for each unrelated trade or business as a whole, so a broader (fewer digits) classification would be more compatible with actual exempt organization trades or businesses.

Even two-digit codes include some ambiguities. For example, case law and IRS rulings indicate that providing certain commercially available administrative or management services for unrelated organizations, even if the recipients are tax-exempt, is an activity that may be unrelated to exempt purposes. Management services could be described by two or more different NAICS two-digit codes. Under the two-digit code 54, they might fall into the four-digit group 5412 (accounting, tax preparation, bookkeeping, and payroll services) or the four-digit group 5416 (management, scientific, and technical consulting services). On the other hand, the introductory description of the two-digit code 54 states: "This sector excludes establishments primarily engaged in providing a range of day-to-day office administrative services, such as financial planning, billing and recordkeeping, personnel supply, and physical distribution and logistics. These establishments are classified in Sector 56, Administrative and Support and Waste Management and Remediation Services." Thus, a reporting exempt organization would need to make a judgment whether the management services it provides fall under 54 or 56 (or perhaps yet another two-digit code).

Despite these ambiguities, using a two-digit classification safe harbor would simplify classification and reporting by exempt organizations (if they were required to use NAICS codes for purposes of Section 512(a)(6)), because they would not need to determine which six-digit code is most applicable or whether two or more codes are applicable. Instead, the exempt organization could locate a classification (whether at level 2, 3, 6, or anywhere in between), then determine the two-digit classification within which the activity belongs. For example, it is not readily evident that advertising activities are included in the two-digit code 54, "Professional, Scientific, and Technical Services." However, a quick keyword search for "advertising" on the U.S. Census Bureau's NAICS site leads to the four-digit code 5418, "Advertising, Public Relations, and Related Services," which is part of the 54 two-digit code.

The following examples illustrate the preferability of using 2-digit NAICS codes as a factor and/or safe harbor in identifying separate trades or businesses, for purposes of Section 512(a)(6), rather than using longer NAICS codes.

Example 1. Overlapping Codes for the Same Activity. A college uses the NAICS six-digit codes to report as separate businesses the UBTI rental of its facilities to third parties for the use of its facilities. The three tenants include: (1) commercial businesses located on the first floor of a building on the edge of campus, (2) members of the general public who stay at the executive education center for basketball games and (3) those few donors and guests who may stay overnight at the luxurious suites in the student union. The school earns a moderate profit on the commercial tenants but derives significant losses on the other two activities.

When reviewing these codes for 'rent' under keyword search tool, NAICS lists 43 codes. Of these codes, it appears that these rental activities may be grouped as one separate business, "lessors of nonresidential buildings (except mini-warehouses)." Accordingly, the exempt entity would report on Form 990-T a loss for these activities and pay no taxes.

However, if the term "hotel" were used in the key search tool rather than "rent," the search would broaden to include hotels as well as lessors of nonresidential buildings (except warehouses). Arguably, in this case, the rentals from the executive education center may be classified as a hotel and possibly the student union, whereas the commercial businesses would most likely continue to be classified as a nonresidential building. Accordingly, the exempt entity would report on its tax return a taxable loss under the first scenario and a taxable gain under the second scenario, resulting in taxes paid to the IRS.

Different word searches may lead to different reporting by various exempt entities for the same activities, resulting in some entities paying taxes whereas others may not. Further, the tax risk of the IRS re-classifying these activities and re-calculating UBTI would increase unnecessarily. Additionally, NAICS updates these codes every five years to reflect the changing economies with "one goal - to modify or create industries to reflect new, emerging, or changing activities and technologies" (page 13 of the NAICS manual). Said differently, continual modification of these codes would add further complexity to reporting these activities, possibly resulting in forfeited losses for any re-classified activity.

Example 2. An Activity that Includes Multiple Codes. A pharmaceutical company hires a medical school to review its research protocol developed for specimens related to various biotechnologies, including nanotechnology, by testing certain specimens in its laboratories over a three-year period. The principal investigator (PI) with the medical school will also serve as a consultant on improving the company's process and implementing recommended practices. The payment is a fixed fee provided in a single contract.

The issues are whether and how the medical school should classify the contract as multiple trades or businesses, for Section 512(a)(6) purposes, and, if more than one trade or business, how should it allocate its revenues and corresponding expenses derived from these services accordingly. Possible applicable codes include the following, among others:

- 541714 - biotechnology research and development laboratories or services in the medical sciences (except nanobiotechnology research and development) is described primarily as involving the study of the use of microorganisms and cellular and biomolecular processes to develop or alter living or non-living materials.

- 541713 - research and development in nanobiotechnology is described as the study of matter at the nanoscale.

- 541614 – medical laboratories is described primarily as providing analytic or diagnostic services, including body fluid analysis, generally to the medical profession or to the patient on referral from a health practitioner.

- 541613 – marketing consulting services is described primarily as customer services management consulting services.

In one scenario, the school may treat the contract as a single separate trade or business using the code for the research of biotechnology (541714) because it is the lead service with the others being ancillary and incidental to the contract as a whole. Or, in another scenario, it may argue that the default code is "marketing consulting services" since the other codes describe activities that, on their face, appear to be substantially related to its tax-exempt purposes and do not derive UBTI.

Alternatively, in a third scenario, the school may treat the contract as having four separate trades or businesses, raising the question of how to allocate the revenues and expenses with a fixed fee provided in the contract. A market comparison may not be not readily available, at least for the first three services, given their complexity and uniqueness. Likewise, the expense allocations may result in multiple allocations for the use of the same facility. For instance, in addition to the traditional allocation of dual use facilities between exempt and taxable activities, i.e. revenues derived from its core research mission and the first taxable activity, additional allocations may then be necessary for the second and third taxable activities, all of which are performed in the same research laboratory.

Given the possible use of multiple codes for the same unrelated trade or business activity/activities, various classifications based on reasonable, good faith interpretations are highly probable, each possibly resulting in different tax liabilities for different exempt organizations under Section 512(a)(6).

As in Example 1, above, the tax risks increase unnecessarily should the IRS disagree with any position taken. Note that the ground upon which the IRS may challenge these six-digit codes would generally be based on a brief factual description of the activity provided by NAICS codes rather than a more complete explanation of how the activity is conducted, possibly misconstruing the essence of the transaction and its purpose.

With widespread inconsistency and higher tax risks, any allocation of revenues and expenses that consistently derive losses, based on the use of these multiple codes, may inadvertently give the impression that exempt entities may be managing the codes to their financial advantage.

Example 3. Code Differs Depending on Perspective. An activity may fit into a number of different six-digit NAICS codes depending on who performs it, where it is performed, for whom it is performed, and for what purpose it is performed. Take the example of a tax-exempt nursing home whose physician medical director consults with a medical device manufacturer on better user interfaces on hospital beds for seniors with limited mobility or sight. The draft instructions for the Form 990-T admonish us to avoid using codes that describe the organization rather than the income-producing activity. Thus, codes describing the nursing home (623110 – Nursing Care Facilities, 623311 – Continuing Care Retirement Communities, or 623312 – Assisted Living Facilities for the Elderly) would not be apposite. However, eight six-digit codes could describe the activity, depending on perspective:

- 339112 Surgical and Medical Instrument Manufacturing
- 334118 Computer Terminal and Other Computer Peripheral Equipment Manufacturing
- 334310 Audio and Video Equipment Manufacturing
- 335210 Small Electrical Appliance Manufacturing
- 337127 Institutional Furniture Manufacturing
- 541690 Other Scientific and Technical Consulting Services
- 541715 Research and Development in the Physical, Engineering, and Life Sciences (except Nanotechnology and Biotechnology)
- 541990 All Other Professional, Scientific, and Technical Services

The ability to use two-digit NAICS codes for a safe harbor and/or as a factor in determining a trade or business, for purposes of Section 512(a)(6), would simplify the analysis – the activity likely would fall into either code 33 or 54. The ability to use two-digit NAICS codes also would focus the analysis on the nature of the activity – is it manufacturing (33) or professional, technical, and scientific services (54)? Because the exempt organization is not actually engaged in manufacturing, NAICS code 54 is likely the better trade or business category. Because finding the most appropriate two-digit code could be a burdensome and frustrating process for certain exempt organizations and their trades or businesses, we would oppose making two-digit NAICS codes the exclusive means of identifying a trade or business. Nevertheless, two-digit NAICS codes are far less burdensome than trying to identify a longer NAICS code.

The Section 132 regulations provide a precedent for using two-digit codes as a factor (but not the exclusive factor) in classifying business activities. In particular, Treas. Reg. §1.132-4(a)(2)-(3) define an employer's line of business, for purposes of the line of business limitations for no-additional cost services and qualified employee discounts, by referencing the codes contained in the Enterprise Standard Industrial Classification Manual (ESIC). The ESIC, the precursor to the NAICS, used two-digit codes to classify certain business activities, including general retail merchandise stores, hotels and other lodging places, and food stores. Treas. Reg. §1.132-4(a)(2) provides that an employer is considered to have more than one line of business if it offers for sale property or services in more than one two-digit ESIC code.

Note that although the Section 132 regulations require consideration of the two-digit codes in determining a line of business, they do not preclude two different activities that could be described by different two-digit codes from being aggregated as a single business, based on a facts and circumstances approach.[4] A similar approach, in which exempt organizations consider two-digit NAICS codes along with other factors set forth elsewhere in the Code and regulations (e.g., 132, 183, 469) to classify their unrelated trade or business activities, would provide a flexible, administrable standard that would enable organizations to reasonably classify complex, ever-evolving business activities, for purposes of Section 512(a)(6).

[4] Treas. Reg. §1.132-4(a)(3) permits aggregation of separate activities into a single line of business if certain factors are met, including (i) it is uncommon in the industry for an employer to perform one line of business without the other(s), (ii) it is common for a substantial number of employees to perform substantial services for more than one line of business for the same employer, and (3) multiple lines of business of an employer conducted on the same premises would normally be considered a single line of business if conducted together in a single store.

III. Characterization of Income Deemed UBTI, But Not Generated from an Unrelated Trade or Business, for Purposes of Section 512(a)(6)

In the comments dated August 13, 2018, members of the TEGE Council proposed that an exempt organization should be able to aggregate gross UBTI and losses for purposes of calculating net UBTI under Section 512(a)(6) from activities that do not meet the Section 513(c) definition of "trade or business," but rather are statutorily deemed to be UBTI such as:

- Receiving interest, rents, royalties, and annuities from controlled entities under Section 512(b)(13);

- Paying to provide qualified transportation fringe benefits to employees under Section 512(a)(7);

- Receiving rental income treated as UBTI under Section 512(b)(3)(B);

- Receiving debt-financed income treated as UBTI under Section 512(b)(4);

- Receiving Subpart F insurance income under Section 512(b)(17); and/or

- Receiving partnership income treated as UBTI under Section 512(c).

Treasury and the IRS should allow exempt organizations to aggregate income and losses from such categories of UBTI because Section 512(a)(6) applies only to unrelated trade or business activities, and the activities listed above are not unrelated trades or business activities. The Code and regulations are clear that unrelated trade or business activities only include the "sale of goods" or the "performance of services" that are unrelated to the organization's mission. See Section 513(c) and Treas. Reg. § 1.513-1(b). The types of income enumerated above are not derived from unrelated trade or businesses activities of the exempt organization; therefore, Section 512(a)(6) should not apply to them.

The justification for the Notice's interim rule that such items are subject to separate computation under Section 512(a)(6) derives from erroneous statutory interpretation. Notice 2018-67, Section 4, provides that

> [t]he 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 that 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).

This statutory interpretation of Section 512(b) is erroneous because it treats the plain and unambiguous language of Section 513(c) as superfluous or irrelevant. It is not the case that passive income such as interest, royalties, rents, etc. would be included in the calculation of UBTI in the absence of the modifications set forth in Section 512(b). The statute is more nuanced than that. In the absence of the Section 512(b) modifications, passive income would only be included in the calculation of UBTI *to the extent that* the activity producing the income meets the definition of an unrelated trade or business set forth in Section 513(c), which is limited the *sale of goods or performance of services*. The statute reflects the justifiable concern on the part of Congress that the IRS could interpret the general definition of unrelated trade or business income from the sale of goods or performance of services so expansively as to sweep in passive income as well, which is why Congress provided the modifications in Section 512(b)—to preclude such overly expansive notions of UBTI.

By suggesting the definition of unrelated trade or business activities should be broadened to encompass passive income and the other UBTI items listed above, the Notice opens the door to serious unintended consequences and spillover effects to UBTI jurisprudence, administrability, and tax policy.

To appreciate the need for a nuanced understanding of UBIT as it applies to passive income, consider the 5th Circuit Court of Appeals opinion *Louisiana Credit Union League v. United States, 693 F.2d 525* (5th Cir. 1982) (offering two-part test for determining whether activities of trade association are substantially related). The case involved income that was nominally a "royalty" eligible for exclusion from UBTI under the Section 512(b)(2) modification, but which was, in fact, income from the performance of services unrelated to the association's mission. The court failed to make the distinction between royalties for the right to use intellectual property and fee-for-services income, so, in *dicta*, the opinion used "profit motive" as the sole criterion needed to identify an unrelated trade or business, effectively reading out the "sale of goods or performance of services" from Section 513(c). These *dicta* suggest, erroneously, that passive income, if earned in the right state of mind (i.e., with a profit motive), could be an unrelated trade or business, regardless of whether it derives from the sale of goods or performance of services. These same *dicta* could be used, again erroneously, to support the position set forth in the Notice that the separate computation rules of Section 512(a)(6) apply to passive income.

The "profit motive" interpretation of Section 513(c) in *Louisiana Credit Union League* is mere *dicta* because the case involved UBTI from the performance of marketing services—an active trade or business under Section 513(c), and not, in fact, income from passive sources. It was, therefore, unnecessary for the court to construe Section 513(c) in a divergent manner from the statute and Treasury Regulations. This case was decided in the midst of the development of the body of law that now enables the IRS reliably to distinguish passive royalty income earned by licensing intellectual property from active income earned by the performance of services. See, e.g., Rev. Rul. 81-178, 1981-2 C.B. 135 (distinguishing royalties for the use of a valuable right from payments for personal services). This useful development in regulatory guidance obviates the need for any such tortured statutory interpretation.

Moreover, the 5th Circuit decision is at odds with a subsequent Supreme Court decision in *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), which states:

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished

> between a business or trade, on the one hand, and 'transactions entered into for profit but not connected with . . . business or trade,' on the other. See Revenue Act of 1916, section 5(a) Fifth, 39 Stat. 759. Congress 'distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business.' *Whipple v. Commissioner*, 373 U.S. 193, 197 (1963).

It would be ill advised for the IRS and Treasury to rely on the 5th Circuit's pre-*Groetzinger* interpretation of Section 513(c) for purposes of Section 512(a)(6) because if every passive investment activity an exempt organization carries on with the intent to produce income were a trade or business, then every dollar of investment income an exempt organization realizes could, theoretically, be a separate trade or business—an unimaginably complex and unadministrable proposition for which there is no statutory support or tax policy justification.

Finally, it would be anomalous to treat passive investment activity as a trade or business for purposes of UBIT because it is not considered a trade or business for purposes of Section 162 or other purposes of the Code. The tax law draws a critical distinction between profit-seeking trade or business and profit-seeking nonbusiness, the latter composed primarily of investment activities. The *Groetzinger* case (which analyzed whether a professional gambler could deduct his gambling expenses) generally provides that a trade or business is a profit-seeking activity conducted "with continuity and regularity" while nonbusiness investment activities generally lack the taxpayer's continuous or regular attention, despite the taxpayer's intent to earn an economic return.[5] This distinction is important because Section 162 allows taxpayers to deduct costs incurred in connection with a trade or business, but not costs incurred in connection with nonbusiness investment activities. The Treasury Regulations interpreting Section 513(c) cross-reference the definition of trade or business under Section 162. There is, therefore, a risk that treating nonbusiness investment activities as a trade or business for purposes of the separate computation of UBTI under Section 512(a)(6) could fuel taxpayer efforts to deduct investment expenses under Section 162. Moreover, Section 212, which enables individual taxpayers and trusts to deduct certain investment expenses, does not use the words "trade or business" to describe investment activities; rather, it provides that "[i]n the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(1) *for the production or collection of income*; (2) for the management, conservation, or maintenance of property held for the *production of income*… ." The fact that Congress wrote a separate code section to provide for the deductibility of investment expenses is itself sufficient to establish that Congress does not view such expenses as deductible under Section 162 and, therefore, that investment activity is not within the ambit of a "trade or business" under Section 513(c).

[5] *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

IV. Consider Investments in Partnership Interests as a Single Trade or Business for Exempt Investors

The exempt organization community invests in partnerships and other vehicles to generate funding that allows it to further its exempt missions, including, in certain cases, assisting the underprivileged, healing the indigent, and educating the less fortunate. As the community has grown, these investments have come to significantly benefit the economy, for instance, one segment of exempt entities, colleges and universities, invested more than $565 billion in businesses in calendar year 2017.[6] Further, over half of these investments are made in alternative investments, defined as nonconventional investments that include private equity, hedge funds, managed futures, real estate, commodities and derivative contracts.[7] Likewise, the Council on Foundations surveyed 143 private foundations and 81 community foundations representing $104.4 billion of endowment assets and found that 43% of the private foundation assets and 27% of the community foundation assets were invested in alternative investments.[8] These statistics suggest that an "average-sized" endowment may be invested in a significant number of alternative investments.

The most popular vehicle of choice for structuring these investments is the limited partnership (LP) in which the exempt investors are limited partners who bear no liability but for their investment and have no decision-making authority over the assets acquired by the partnership. Another similar investment vehicle, although not as commonly used, is the limited liability company (LLC) in which the exempt investor is a non-managing member of the partnership. Similar to the role of LP, the non-managing member makes no decisions regarding the operations of this investment. Additionally, there are new investment models being introduced each year. For example, many large exempt investors are currently structuring "fund of one," which generally result in better fee structures and offer investors more tailored investment guidelines to fit the investors' risk profile. This "fund of one" is typically organized with the exempt investor as the sole limited partner in the fund, resulting in a high percentage of ownership (90% or more) but no more control over the partnership's activities than the investor would have in an investment partnership in which the investor has a very small percentage of ownership.

In accordance with the Internal Revenue Code (IRC), the partners are responsible for the resulting tax liability rather than the partnership. The partnership provides a Schedule K-1[9] each year to its partners and members, taxable and exempt investors alike, that allocates each investor's share of partnership income to be reported on their income tax returns. Exempt investors report their allocated unrelated business taxable income (UBTI) on the Form 990-T.[10] Exempt investors not subject to the passive loss limitations rules under Section 469 (typically organizations not formed as trusts such as pension plans, employee benefit trusts and certain charitable foundations) may

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[6] 2017 NACUBO, Commonfund Study of Endowments which includes 809 private and public colleges and universities associated with the National Association of Colleges and University Business Officers (NACUBO).

[7] 2017 study above, 52% of the participants invested their assets in alternative investments.

[8] 2018 Council on Foundations, Commonfund Study of Investment of Endowments for Private and Community Foundations.

[9] Schedule K-1 (form 1065), Partner's Share of Income, Deductions, Credits, etc.

[10] Form 990-T, Business Income Tax Return for Exempt Organizations.

use losses from these partnerships to offset gains from any and all other UBTI activities without restriction.

Exempt organizations that are limited partners or non-managing members in investment partnerships rely heavily on the general partner to report their tax information appropriately since they have no control over or access to the activities that generated the income. Exempt investors are particularly concerned since UBTI is a subset of partnership income, meaning not all income reported on the Schedule K-1 is subject to tax. In accordance with IRC section 6031(d), the general partner, as representative of the partnership, is obligated to include such information as is "…necessary to enable each exempt partner to compute its distributive share of partnership income or loss from such trade or business in accordance with IRC section 512(a)(1)." However, this reporting varies and, in virtually all cases, does not include any explanation or provide any authority to support its determination of UBTI. The exempt investor is challenged to manage this potential disparity or 'gap,' oftentimes entering into side letters with the general partners to ensure accuracy and establishing regular communications to verify this information.

The Notice provides that an exempt partner in a partnership that has multiple activities, whether through direct investment or as a partner in other partnerships, may be engaged in multiple unrelated trades or businesses because, as a flow-through entity, the activities of the partnership are attributed directly to the partner. Since many of these LPs or LLCs invest in other partnerships or "fund of funds," the additional burden imposed on the general partner or managing member to report the separate activities may be overwhelming and, in fact, may be extremely difficult to comply with. This is particularly true if the initial LP or LLC does not have control or significant influence over the downstream investments. Accordingly, the IRS proposed to ease this administrative burden in an effort to manage this 'gap.'

The Notice provides the *Interim* rule that allows the exempt investor to treat qualifying partnership interests (QPI) as one trade or business rather than as multiple businesses. Further, this rule allows the exempt investor to offset losses from one partnership with gains from another when the investor meets either the *de minimis* test or *control* test. The de minimis test is met if an exempt investor owns no more than 2% of the profits interests and no more than 2% of the capital interests in a partnership. The control test is met if an exempt investor owns no more than 20% of the capital interest and does not have control or influence over the partnership. The intent is to treat partnerships as a single trade or business when the exempt investors have no control or significant influence over an LP or LLC. It should be noted that both tests require combining the ownership interests of disqualified persons, supporting organizations and controlled entities to determine whether the ownership thresholds are met.

The *Interim* rule does not comport with the way exempt investors manage investable assets. Although in some states, limited partners and non-managing members may be able to vote on basic issues such as removing a general partner or managing member for matters of conflict of interests, etc., in virtually all cases, they have no right to direct, manage, supervise or engage in activities conducted by the partnerships and the lower-tier partnerships in which these partnerships invest. True to the nature of passive investments, the exempt investor's decision-making as a limited partner is curtailed to the threshold question of whether to invest in the initial partnership for the sole purpose of earning funds to support its mission. Further, exempt investors manage these investments as a single activity, typically in a central office to maximize investment income, growth and returns. These investments serve the same narrow purpose: to generate funds to allow the exempt entity to more effectively carry out its mission. As limited liability investments, they present few if any financial risks to the exempt entity beyond the fluctuation of the value of their investments in the LPs and potential UBTI. The activity is limited to selecting investments at a high level (i.e., the partnership itself and not the underlying investments that could generate UBTI), making the requisite contributions to the partnerships and accounting for them accordingly. This is especially appropriate for a pension plan, employee benefit trust, or an endowment in which investing is a significant activity of the organization. Accordingly, an exempt investor that is a limited partner or non-managing member regardless of its percentage of ownership generally does not exercise any control over the various activities entered into or conducted by these partnerships.

We recommend that exempt investors be allowed to treat all partnership investments made as part of a diversified portfolio of investments in which the exempt investor is invested as a limited partner or non-managing member as a single activity, regardless of the investor's percentage of ownership. This approach would result in exempt investors aggregating all UBTI from partnerships. This aggregation would also significantly reduce the IRS's burden of examination in connection with auditing an exempt investor with numerous investment assets in a diversified investment portfolio. Such treatment is consistent with Section 513(c) which does not expressly include investments activities when defining a "trade or business" as an activity "carried on for the production of income from the sale of goods or the performance of services." It also furthers the intent of the Treasury Department and IRS as stated in the Section 5.02 of this Notice, to treat certain investment activities as one trade or business for purposes of Section 512(a)(6).

If the Service were to reject our recommended approach, there are some specific concerns we have related to the approach contained in the Notice:

The *Interim* Rule:

- While the *Interim* rule outlined in Section 6 of the Notice is a starting point to assist exempt investors in aggregating certain QPI into one trade or business activity, we request that the Service modify the rule, primarily to ease the burden of determining which partnership interests would qualify. We believe the *de minimis* and *control* tests are too limiting and would impose a significant burden on both the exempt investor as well as the IRS.

  We recommend the rules for determining a QPI should be aligned with other provisions in the IRC, regulations or tax form filing instructions. For instance, the *Interim* rule outlined in the Notice appears to reflect IRC section 4943, regarding the excess business holding rules applicable to private foundations and certain supporting organizations. However, there are enough differences between these two rules to confuse not only tax preparers, but the organizational employees and volunteers pulling together the information for the Form 990-T. Providing rules that use the same terminology but which are applied differently would make it more likely the rules will not be complied with correctly. Therefore, we recommend the rules be written in a manner that is easy to implement and/or aligned with other IRC sections.

  Many exempt investors invest in numerous entities classified as partnerships for tax reporting purposes. Determining the common ownership information from all the related parties, including disqualified persons, is onerous. Many affected public charities have large boards with over one hundred members. It would be unreasonable to verify the ownership percentages for every partnership holding that generates unrelated business taxable income by the exempt investor. The exempt investor often cannot ask the partnership for a list of investors along with their ownership percentages due to confidentiality agreements. Therefore, the exempt investors would need to ascertain that information by asking their related parties. Many exempt investors with large boards would find this task extremely burdensome if not impossible. Our recommendation to treat all investment partnerships as one activity would eliminate having to combine the 'disqualified persons' ownership interests and would avoid, invasive conversations with officers, directors, trustees, and, possibly, donors. Where hundreds of investments are involved, such communications would create tremendous administrative burden that would almost certainly never produce a truly accurate result.

If our recommended approach is not adopted, we suggest including a reasonable efforts standard similar to the one included in Form 990, Part VI line 2, Part VII, and Schedule L instructions, which provide that an organization can satisfy certain reporting requirements by making a reasonable effort to obtain information from third parties. This may entail distributing an annual survey to the disqualified persons to determine if they hold an interest in these partnerships.

- The *de minimis* test for determining a qualifying partnership interest should be simplified and not require the exempt investor to combine its ownership with related interests. Even the overly prohibitive provisions of IRC section 4943 allow a private foundation to disregard the holdings of disqualified persons and commonly controlled private foundations if the ownership in the investment is 2% or less. Similarly, IRC section 951 provides US shareholders must own 10% or more of a foreign corporation to begin the analysis of whether there is a controlled foreign corporation. A less than 10% ownership interest is therefore deemed *de minimis*. If an exempt investor owns a limited interest in a partnership investment it would be more reasonable for related interests not to be taken into account for purposes of the *de minimis* test. It also would be more reasonable to increase the ownership percentage from 2% to 10%.

- The *control* test for determining a qualifying partnership interest also involves an unreasonably low threshold of influence or control and does not seem to be reflective of the current state of passive investment structuring. It is not reasonable to have the ownership threshold limited to 20%, especially when it includes combined related interests. If an exempt investor is a limited partner, then by definition it does not have control or influence over the investment partnership. This is true even in the case of a 'fund of one' in which the investor is the only LP and owns more than 90% of the partnership interests. Investors, including exempt investors, have invested via these structures to reduce fees and improve investment performance to support their missions, not for the purpose of controlling the investments held by the partnership. As such, there are a couple of options that provide a better measure of control: (1) if an exempt investor is acting as the general partner or is not paying fees to a professional money manager to act as a fiduciary in selecting investments for the partnership, or (2) the standards applicable under FASB Accounting Standards Codification 810 addressing the presumption of control (e.g., the exempt investor would have a substantive ability to dissolve the partnership or otherwise remove the general partner without cause, substantive participation rights in making important financial and operating decision-making processes for the partnership, and the ability to influence the general partner and overall management of the partnership). If the foregoing recommendations are not acceptable to the IRS it would be more reasonable to raise the threshold to greater than 50% ownership to align with what is considered control for purposes of IRC section 512(b)(13) and the reporting requirements for Schedule R of Form 990.

Transition Rule:

- Additionally, the Notice puts forth the *Transition* rule, which allows an exempt organization to treat any partnership interest acquired prior to August 21, 2018 that fails to meet the *Interim* rule as a single trade or business without regard to any underlying activities carried on by the partnership. This rule provides relief for some partnership investments that meet neither the de minimis test nor control test. As a point of distinction, *the Transition* rule does not allow the exempt investor to aggregate UBTI from any other partnerships, even those that qualify under the *Transition rule*.

  Under the Notice, the relief provided under the *Transition* rule will not apply to investments entered into after August 21, 2018. In the case of partnership interests that are acquired after August 21, 2018 for which an exempt investor cannot meet the *Interim* rule, exempt investors would need to report each activity within the investment partnership as a separate activity if the *Interim* rule and *Transition* rule are finalized without any further modifications.

  A significant reporting and administrative burden will exist if exempt organizations are required to separately track each activity within an investment partnership as a separate activity. For the foregoing reasons, the *Transition* rule should apply to all partnership interests whether or not acquired before a particular date.

As much as the *Interim* and *Transition* rules attempt to reduce the administrative burden and help to manage the gap in reporting UBTI, they still would result in significant administrative burden for exempt investors and for the IRS, both in terms of reporting and auditing, if finalized. For instance, the *Interim* rule does not include those investments in which exempt investors hold ownership interests greater than 21%, even though as an LP the exempt investor has no control over the partnership. Also, the relief provided by the Notice should more clearly address those exempt investors whose ownership interests may increase or decrease in an unforeseeable manner and due to factors entirely outside of exempt investors' control, such as the termination or reduction of other partners' interests, an increase or decrease in the total partnership interests issued, or as capital calls are met (or are failed to be met) by all partners in the partnership, or simply due to the timing of an investment (e.g., an exempt investor may be the initial investor in a fund and others enter in subsequent closings). Clarifying language should be added to the *Transition* rule to expressly provide that these or other changes in ownership percentages do not prevent the partner from continuing to treat its entire partnership interest as comprising a single trade or business for purposes of Section 512(a)(6). The Notice does not address these changes in investment ownership interests at all. Will exempt investors be able to be treat such investments as a single trade or business under the *Interim* rule if their interests in an investment partnership grow or decline? Will their interests qualify under the *Transition* rule if they are required by the partnership to make subsequent contributions or ownership percentages otherwise change? And what would happen to the net operating losses generated under one rule set if and when the investment moves to another rule set? For the foregoing reasons, once an exempt investor has a partnership interest that qualifies under the *Transition* rule or an "investment activities" partnership interest that qualifies under the *Interim* rule, it should not matter whether the percentage of ownership fluctuates over time.

Both the *Interim* and *Transition* rules would result in certain limited partners with no control or significant influence over certain partnerships being subject to this new layer of reporting, which may frustrate and possibly hinder their management of these reported tax liabilities. Moreover, the burden of these rules may restrict marketability to the point that the general partners of certain partnerships may refuse to allow exempt investors to participate as limited partners in investment opportunities. Other general partners may charge excessive fees to account, track, monitor and report information from various investments, which taxable investors may not be willing to share. All of the foregoing would result in less capital being available to the markets to grow businesses and the economy. Those results clearly cannot be what was intended by Congress in enacting Section 512(a)(6).

Treatment of S Corporations:

The Notice does not provide guidance for reporting UBTI received from investments in S corporations. The statutory language of IRC section 512(e) favors treatment of income received by an exempt investor from an S corporation as income received from one trade or business. IRC section 512(e)(1)(A) provides that if an applicable exempt organization holds stock in an S corporation, such interest shall be treated as an interest in an unrelated trade or business. The statutory language denotes that an exempt investor only holds an investment in one trade or business, despite the different sources of income the exempt organization earns from an S corporation investment.

Section 4 of the Notice provides that significant burden may be imposed on exempt investors if they are required to separately track income, that is not income from a partnership, but is "…included in UBTI under IRC sections 512(b)(4), (13), and (17)." Section 5 of the Notice raises similar concerns relating to reporting unrelated business income from partnership investments. Exempt investors must report all income derived from an S corporation investment as UBTI, no matter the source. A significant reporting and administrative burden would exist if exempt organizations were required to separately track and categorize different S corporation investments or different sources of income received from an S corporation investment.

Thus, we recommend allowing exempt investors to aggregate unrelated business income produced from S corporation investments together with unrelated business income produced from partnership investments. Since both types of investments are pass through investments and generate a Schedule K-1, such a rule would simplify UBTI calculation and reporting. This principle has been previously recognized as both the prior Forms 990-T and draft 2018 Form 990-T allow exempt organizations to report income and losses from partnerships and S corporations on one line together. If this recommendation is not adopted, we suggest that unless an exempt investor holds a controlling interest in an S corporation of more than 50%, the exempt investor should be allowed to aggregate multiple interests in S corporations together with partnership investments as a single trade or business.

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We hope that these comments are helpful to you as you provide further guidance on these important issues. Thank you for your consideration.