



December 3, 2018

***By Electronic Delivery***

Internal Revenue Service  
CC:PA:LPD:PR (Notice 2018-67), Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044

RE: Notice 2018-67: Unrelated Business Taxable Income

Ladies & Gentlemen:

The Asset Management Group (“AMG”)<sup>1</sup> of the Securities Industry and Financial Markets Association (“SIFMA”) appreciates the opportunity to provide input to the U.S. Department of the Treasury (“Treasury”) and Internal Revenue Service’s (“IRS”) request for comments to Notice 2018-67<sup>2</sup> (“Notice”) regarding the calculation of unrelated business taxable income (“UBTI”) under section 512(a)(6) of the Internal Revenue Code<sup>3</sup> for exempt organizations with more than one unrelated trade or business; interim and transition rules for aggregating certain income in the nature of investments; and the treatment of global intangible low-taxed income inclusions (“GILTI”) for purposes of the unrelated business income tax (“UBIT”).

**I. Overview**

Section 13702 of P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act of 2017, or the “TCJA”) added new section 512(a)(6) to the Code. Section 512(a)(6) requires organizations exempt from tax who operate more than one unrelated trade or business to compute UBTI separately for each trade or business (without regard to the specific deduction under section

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<sup>1</sup> SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG’s members represent U.S. and global asset management firms whose combined assets under management exceed \$39 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit <http://www.sifma.org/amg>.

<sup>2</sup> Request for Comments Regarding the Calculation of Unrelated Bus. Taxable Income Under 512(a)(6) for Exempt Organizations with More Than One Unrelated Trade or Business; Interim & Transition Rules for Aggregating Certain Income in the Nature of Investments; & the Treatment of Glob. Intangible Low-Taxed Income Inclusions for Purposes of the Unrelated Bus. Income Tax, 2018-36 I.R.B. 409 (2018).

<sup>3</sup> Except as otherwise expressly provided herein, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

512(b)(12)). Under this provision, an organization's UBTI for any tax year would be the sum of the amounts (not less than zero) computed for each separate trade or business, less the section 512(b)(12) specific deduction (which is currently \$1,000).

## **II. Issues Identified in Notice 2018-67**

### **A. Treatment of Investment Activities**

Sections 512(b)(1), (2) and (5) specifically provide that certain types of income are excluded from UBTI, even if such income arises in an unrelated trade or business. Income excluded generally includes investment income such as dividends, interests, payments with respect to securities loans, and royalties (and rents in certain instances) and recognized gains and losses on investment property, as well as all deductions directly connected with such income.<sup>4</sup> Thus, under a plain reading of the statute, it is clear that these investment activities are not considered a trade or business activity subject to the UBIT.

The Notice underscores this point by citing to legislative history that concludes “investment-producing incomes of these types have long been recognized as a proper source of revenue for [exempt] organizations and trusts.”<sup>5</sup> The addition of section 512(a)(6) to the Code did not change this fundamental rule. Thus, we recommend that investment activities be separated out prior to making any determinations under section 512(a)(6) as to whether or not an exempt organization is engaged in more than one unrelated trade or business.

### **B. Methodologies for Identifying Investment Activities and Unrelated Trade or Businesses for purposes of section 512(a)(6)**

#### **1. *Reliance on North American Industry Classification System 6-digit Codes***

The Notice provides that Treasury and the IRS are considering the use of North American Industry Classification System (“NAICS”) codes to provide additional guidance in proposed regulations for determining whether an exempt organization has more than one unrelated trade or business for purposes of section 512(a)(6) and how to identify separate trades or businesses for purposes of calculating UBTI under section 512(a)(6)(A). The Notice further provides that Treasury and the IRS consider the use of NAICS 6-digit codes to be a reasonable, good-faith interpretation under the Notice.

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<sup>4</sup> Sections 512(b)(1), (2) & (5).

<sup>5</sup> Notice 2018-67 at 5, citing S. Rep. No. 81-2375 at 30-31 (1950).

The NAICS is an industry classification system created for purposes of collecting, analyzing, and publishing statistical data related to the United States' business economy.<sup>6</sup> The Notice indicates that it believes the use of the 6 digits of the NAICS codes would result in more specific categories of trades or businesses. While SIFMA AMG supports the concept of using the NAICS codes for identifying more than one trade or business, our members are concerned that the use of the NAICS codes are not specific enough for purposes of identifying investment activities. There are only two NAICS codes that deal with investment activities. We are concerned that these two codes do not adequately describe all investment activities engaged in by certain exempt organizations. Thus, we would recommend that investment activities be separated out prior to the application of this principle and that exempt organizations be allowed to use this methodology on an elective basis.

## 2. *Fragmentation Principle*

The Notice provides that the fragmentation principle may have utility in identifying separate trades or businesses for purposes of section 512(a)(6)(A) of the Code. The fragmentation principle provides that an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of an organization. We are concerned that the fragmentation principle would inadvertently characterize certain investment activities that are intended to be outside of the scope of section 512(a)(6) as an unrelated business. Thus, we would recommend that investment activities be separated out prior to the application of this principle and that exempt organizations be allowed to use this methodology on an elective basis.

## 3. *Use of Other Code Sections to Identify More Than One Unrelated Trade or Business*

The Notice lists several code sections where defining a trade or business may be relevant for purposes of identifying one or more trade or business, such as sections 132, 162, 183, 414 and 469 of the Code. While we understand the desire of Treasury and the IRS to have a more administrable system to identifying separate trades or businesses than just “facts and circumstances alone,” we believe that some concepts from existing code sections could be helpful in identifying separate trades or businesses. In particular, we believe that section 469 has a relevant established body of case law and could provide important guidance.

We believe that as you work through the examples provided below, it is clear that the distinctions and analysis made in section 469, such as “material participation” versus “passive involvement” in a trade or business, are more likely to capture when a taxpayer is engaged in a separate trade or businesses, particularly when operated through partnerships. In section 5 of the

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<sup>6</sup> See EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM (2017), available at [https://www.census.gov/eos/www/naics/2017NAICS/2017\\_NAICS\\_Manual.pdf](https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf).

Notice, Treasury and the IRS look at investment activities and conclude that Section 6 of the Notice should only capture partnership interests where the exempt organization does not significantly participate in any partnership trade or business. While Section 6 uses two bright-line rules to determine significant participation (a de minimis test and a control test), the use of these tests seems to suggest that section 469 provides useful concepts. As discussed below, we believe that the application of these concepts could be a complement to the use of NAICS codes.

C. Income from Activities of a Partnership

1. *Aggregation of Gross Income and Directly Connected Deductions for Partnership Investment Activities*

An exempt organization may conduct an unrelated trade or business directly or indirectly through another entity, such as a partnership. Section 512(c) provides that, if a trade or business regularly carried on by a partnership of which an exempt organization is a partner is an unrelated trade or business with respect to such organization, the exempt organization includes in its UBTI its distributive share of partnership gross income and deductions directly connected with such gross income.<sup>7</sup> Thus, UBTI could include an exempt organization's share of the partnership's gross income when the exempt organization is a partner and the partnership is engaged in one or more unrelated trades or businesses.

The Notice provides that as a matter of administrative convenience, Treasury and the IRS intend to propose regulations treating certain investment activities of an exempt organization as one trade or business for purposes of section 512(a)(6)(A). Thus permitting exempt organizations to aggregate gross income and directly connected deductions from such investment activities. Treasury and the IRS expect that treating these investment activities as one trade or business for this purpose will reduce the reporting and administrative burden on organizations required to comply with section 512(a)(6) and will also reduce the burden the IRS may experience in implementing and enforcing section 512(a)(6). We agree with this approach and encourage Treasury and the IRS to adopt rules that will allow exempt organizations to aggregate gross income and directly connected deductions from such investment activities. We believe that such a rule will reduce administrative burdens on both taxpayers and the government.

2. *Use of Section 469 as Basis of Identifying Investment Activities.*

Section 6 of the Notice provides that with respect to partnership interests that could be included in the category of "investment activities" for purposes of section 512(a)(6), "investment activities" should capture only partnership interests in which the exempt organization does not significantly participate in any partnership trade or business.<sup>8</sup> We agree with this statement and believe that the definition of material participation in section 469 is the most appropriate way of separating out more active involvement in an unrelated trade or business. Section 469 concepts

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<sup>7</sup> Section 1.512(c)-1 of the Income Tax Regulations.

<sup>8</sup> Notice 2018-67, *supra* note 2, at 18.

such as material participation versus passive involvement in a trade or business are more likely to accurately draw the distinction between those partnership interests that do and do not significantly participate in a partnership's trade or business.

Treasury and the IRS have indicated that they have received comments suggesting that the definition of material participation in section 469 could serve as a basis for separating investment activities from more active involvement in an unrelated trade or business. Treasury and the IRS are concerned, however, that the criteria for finding material participation under section 469 is not the best means of making this distinction. We respectfully disagree. We believe that the section 469 concept of material participation in a trade or business is more likely to capture a taxpayer's active engagement in a trade or businesses operated through a partnership.

3. *Methodologies Described in Interim Guidance for Aggregating Partnership Interests*

a. *De Minimis Rule*

The Notice provides that pending publication of proposed regulations, 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 meets the requirements of **either** the de minimis test **or** the control test.<sup>9</sup> Additionally, under this interim rule, an exempt organization may aggregate all qualifying partnership interests and treat the aggregate group of qualifying partnership interests as comprising a single trade or business for purposes of section 512(a)(6)(A).

Under the Notice, a partnership interest meets the requirements of the de minimis test if the exempt organization holds directly no more than 2 percent of the profits interest and no more than 2 percent of the capital interest. We support the de minimis rule.

b. *Control Test*

Under the Notice, a partnership interest is a qualifying partnership interest that meets the requirements of the control test if the exempt organization (i) directly holds no more than 20 percent of the capital interest; **and** (ii) does not have control or influence over the partnership. The Notice further provides that all facts and circumstances are relevant for determining whether an exempt organization has control or influence over a partnership. An exempt organization has control or influence if the exempt organization may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership. An exempt organization also has control or influence over a partnership if any of the exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time, or if the

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<sup>9</sup> *Id.* at 19.

exempt organization has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees.

We have several concerns about the 2-prong control test. First, we don't believe that the percent of capital interest is relevant in determining control. A partnership interest may be passive even if the capital interest is significant. With respect to the second prong of the test, we are concerned that the definition provides that the exempt organization cannot have any perceived control or influence over the partnership. There are instances where control does not exist even though the exempt organization may require the partnership to act or refrain from taking an action. The Notice also states an exempt organization has control or influence over a partnership if any of the exempt organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership or conduct the partnership's business at any time. We do not believe that this factor necessarily illustrates control. Nor is there control if the exempt organization has the power to appoint or remove any of the partnership's officers, directors, trustees, or employees through such provisions which are commonly referred to as a kick out clause.

#### D. GILTI

Treasury and the IRS have determined that an inclusion of GILTI under section 951A(a) of the Code should be treated in the same manner as an inclusion of subpart F income under section 951(a)(1)(A) for purposes of section 512(b)(1) and (4). Accordingly, an inclusion of GILTI will be treated as a dividend which is generally excluded from UBTI under section 512(b)(1). We agree with this analysis and urge Treasury and the IRS to adopt a final rule consistent this approach.

### **III. Proposed Regulatory Language & Examples for Partnership Interests**

The following language is proposed regulatory language that we believe would better address the rationale for determining when a separate trade or business exists for purposes of section 512(a)(6). The proposed language (i) would reiterate that investment activity is not a trade or business under the UBTI rules, and (ii) uses existing concepts for determining how to group unrelated trade or businesses in order to apply the new rule, with a particular focus on administrability.

As stated earlier, we believe that the material participation concept under section 469 of the Code is more likely to capture taxpayer engagement in a trade or business operated through a partnership.

### ***Recommended Material Participation Language***

(a) General rules for determining the activities that constitute a trade or business. The determination of trade or business activities for purposes of applying this section is subject to the following rules:

- (1) Passive trade or business activities. One or more trade or business activities in which the organization or its employees do not materially participate as determined under section 469 shall be considered as a single trade or business activity for the computation of UBTI.
- (2) Active trade or business activities. One or more trade or business activities in which the organization or any of its employees materially participates may be treated as a single trade or business activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

#### **A. Examples**

##### **(1) Investment Activity.**

(A) Organization Z is exempt from tax. Organization Z invests in Investment Fund Y, which is a fund that invests on behalf of its investors in equities, bonds, securities and other similar instruments that give rise to interest, dividends, capital gains/losses and other similar investment income. Organization Z does not manage the investments, but does have employees that materially participate in monitoring the investment activity of Investment Fund Y on behalf of Organization Z to ensure that Organization Z has funds available for the performance of its exempt function. The income earned by Organization Z arising from its investment in Investment Fund Y is not subject to the UBIT because of the exceptions under section 512(b) for investment income such as interest and dividends. Therefore, since the investment activity does not constitute a trade or business activity engaged in by Organization Z, the income does not have to be separately stated and is not subject to UBIT.

(B) Same facts as above, except Organization Z has Employees A, B, and C who each materially participate in managing Organization Z's portfolio of investments. Organization Z is not engaged in a trade or business with regards to its investment activities and the income earned is not subject to the UBIT because of the exception provided under section 512(b) for investment income such as interest and dividends. The material participation of Employees A, B, and C in the investment activity do not make the activity a trade or business.

(2) Passive Trade or Business Activity.

(A) Organization X is exempt from tax. Organization X is a limited partner in Partnership A and in Partnership B, both of which actively conduct a trade or business. Organization X does not materially participate in the trade or business conducted by Partnership A or B. Organization X does have employees that materially participate in monitoring the investment activity of Partnerships A & B on behalf of Organization X to ensure that Organization X has funds available for the performance of its exempt function, and as part of that activity reviews the financial performance of Partnerships A and B and participates in meetings where information about the economic performance of Partnerships A and B is shared with the partners of both Partnerships. Organization X, as a partner in Partnerships A and B, is engaged in a trade or business activity with respect to both Partnership A and B, and is subject to the UBIT on gross income less deductions directly connected with the carrying on the trade or business of Partnerships A and B. Under section 469, Organization X is considered a passive investor in both Partnership A and B. Therefore, for purposes of computing UBTI, Organization X treats the gross income less deductions from Partnerships A and B as a single passive trade or business activity, and gross income and deductions directly connected with the carrying on of both businesses is combined when calculating UBTI (but cannot be less than zero) before Organization X determines its overall UBIT.

(B) Facts are the same as Example (2)(A), except Organization X is also a limited partner in Partnerships C and D, both of which conduct an active trade or business. Employees of Organization X participate in meetings where information about the economic performance of Partnerships C and D is shared with the partners of both partnerships. Organization X also has Employee A, who as part of Employee A's regular duties, sits on the Limited Partner Advisory Committee ("LPAC") of Partnerships C and D. As a member of the LPAC, Employee A's role is advisory only and does not obligate the general partner to act in accordance therewith. As such, Employee A as a member of the LPAC provides advice on such matters as: (i) replacement of key persons; (ii) approving any distributions; (iii) approving any amendments or modifications to the investment limitations of the partnership; (iv) approving the amount of time allowed for an orderly liquidation of the assets of the partnership; and (v) providing general advice with regard to partnership investment activities.

Even though Employee A is a member of the LPAC, neither Employee A nor any other employee of Organization X materially participates in the trade of business of Partnerships C or D. Organization X treats the gross income less deductions from Partnerships C and D as passive trade or business income and the gross income and deductions from Partnerships C and D are combined with the gross



income and deductions from Partnerships A and B as a single passive activity. Gross income less deductions from Partnerships A, B, C, and D will be combined for purposes of determining the net income from passive trade or businesses (but cannot be less than zero) before Organization X determines its overall UBIT.

(3) Active Trade or Business Activity

(A) Facts are the same as Example (2)(B), except Organization X (a university) also owns Business 1 and Business 2. Both Business 1 and Business 2 are operated as divisions within the Organization X, employees of Organization X materially participate in both businesses, and both businesses are unrelated to Organization X's exempt function. Business 1 is a hotel located on the grounds of the university. Business 2 operates an organic farm on grounds of the university. Organization X treats Business 1 and Business 2 as two separate trades or businesses. To calculate UBIT, Organization X must determine its UBTI for Business 1 and Business 2 separately. Once the UBTI is determined separately for Business 1, Business 2, and all passive business activity, all income from unrelated trade or business activities is combined to determine Organization X's UBIT liability.

(B) Organization Y is an organization exempt from tax. Organization Y operates Businesses 1, 2, 3, and 4 as divisions within Organization Y, employees of Organization Y materially participate in all the businesses, and all four businesses are unrelated to Organization Y's exempt purpose. Business 1 is a bookstore and Business 2 is restaurant, both operated in Location A. Business 3 is a bookstore and Business 4 is restaurant, both operated in Location B, which is in a neighboring State. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping Organization Y's activities. Depending on the relevant facts and circumstances, the following groupings may, or may not, be permissible: a single activity; a bookstore activity and a restaurant activity; a Location A activity and a Location B activity; or four separate activities. Once Organization Y groups these activities into appropriate economic units, Organization Y must continue using that grouping in subsequent taxable years unless a material change in the facts and circumstance makes it clearly inappropriate. Once Businesses 1, 2, 3, and 4 have been grouped into appropriate economic units, UBTI must be determined separately for each trade or business unit, before all income from unrelated trade or business activities (cannot be less than zero) is combined to determine Organization Y's UBIT liability.

(C) Same facts as Example (3)(B), except Organization Y operates each business as an equal partner with Business Z. Organization Y and Business Z each are 50 percent partners in the business. Businesses 1, 2, 3, and 4 have employees that

are distinct from Organization Y and Business Z. Organization Y, through its employees and volunteers, materially participates in Businesses 1, 2, 3, and 4. For example, Organization Y advises Businesses 1 and 3 as to what items to stock in the bookstore and uses the bookstore to provide employment opportunities to persons affiliated with Organization Y. With regard to the restaurants, Organization Y advises on menu choices, ingredients, and generally ensures that the food options meet standards set by Organization Y, and uses the restaurant to provide employment opportunities to persons affiliated with Organization Y. As in the example above, once Organization Y groups these activities into appropriate economic units, Organization Y must continue using that grouping in subsequent taxable years unless a material change in the facts and circumstance makes it clearly inappropriate. Once Businesses 1, 2, 3, and 4 have been grouped into appropriate economic units, the UBTI must be determined separately for each trade or business unit, before all income from unrelated trade or business activities (cannot be less than zero) is combined to determine Organization Y's UBIT liability.

#### (4) Unrelated Debt Financed Income

- (A) Partnership A is formed between Organization X and Operator Z. The partnership agreement provides that (i) Organization X shall be the equity investor and Operator Z will be the operating partner (ii) Organization X and Operator Z own 99% and 1% of the gross, income, deductions, gains and losses of Partnership A, respectively, and (iii) Organization X and Operator Z will each have one vote on certain items relating to capital decision making and legal protections. Organization X invests \$19M of its own cash, not subject to acquisition indebtedness, and Operator A invests \$1M. The partnership purchases as its sole asset an office building which is leased to an unrelated third party. The office building cost the partnership \$20M of which 100% was financed using cash. Under section 469, Organization X is considered a passive investor in Partnership A. In this situation, since none of the office building's basis was acquired using debt, no portion of the office building is treated as debt-financed property under Treasury Regulation 1.514(b)-1. Assuming no service income, none of the gross income or deductions from Partnership A will be considered UBTI and therefore will not be considered in determining a trade or business activity for purposes of this regulation.
- (B) Assume the same facts as stated above except that the office building is financed with \$15M of cash and \$5M of debt from Bank Y and Organization X is a tax exempt entity not qualified under section 514(c)(9). This loan is secured by a first mortgage on the office building. Gross income and deductions from Partnership A, subject to the acquisition indebtedness of the office building, will be considered UBTI to Organization X. Since Organization X is considered a passive investor in Partnership A for purposes of IRC section 469, Organization X's share of Partnership A's UBTI

will be considered a single trade or business activity with other passive trade or business activity that Organization X owns.

- (C) Assume the same facts as above, except Organization X is qualified tax exempt under section 514(c)(9). None of the gross income or deductions from Partnership A will be considered UBTI and therefore will not be considered in determining a trade or business activity for purposes of this regulation.
- (D) Organization X is exempt from tax and owns an apartment building. Organization X also is an investor in Partnerships A and B, which are considered passive investments (see Example 2(A)). Organization X converts the building to condominium units, and employees of X materially participate in the sale of the units. To calculate UBIT, Organization X must determine its UBTI for its condo business separately. Once the UBTI is determined separately for the condo business, all passive business activity income, and all income from unrelated trades or businesses is combined to determine Organization X's UBIT liability.

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#### IV. Conclusion

Thank you for considering the foregoing comments. Should you have any questions, please feel free to reach out to Payson Peabody at 202-962-7300 or [ppeabody@sifma.org](mailto:ppeabody@sifma.org) or Lindsey Keljo at 202-962-7312 or [lkeljo@sifma.org](mailto:lkeljo@sifma.org).

Sincerely,



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