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June 23, 2020

By electronic submission (http://www.regulations.gov)

Internal Revenue Service
CC:PA:LPD:PR (REG-106864-18)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

To Whom It May Concern:

The Church Alliance appreciates the opportunity to submit these comments in response to the notice of proposed rulemaking released by the Internal Revenue Service and the Department of the Treasury (collectively, "the Agencies") regarding "Unrelated Business Taxable Income Separately Computed for Each Trade or Business" (REG-106864-18).

I. Background

The Church Alliance is a membership organization composed of thirty-seven church benefits organizations, covering mainline and evangelical Protestant denominations, Jewish entities, and Catholic schools and institutions. The Church Alliance members provide employee benefit plans, including retirement and/or health coverage, to approximately one million clergy, lay workers, and their families, serving over 155,000 churches, synagogues, and religious organizations throughout the country, such as schools, universities, early childhood centers, nursing homes, and food banks.

Church Alliance members sponsor or administer and maintain retirement and welfare benefit programs, which are generally multiple-employer in nature, for eligible employees within the denomination. Having a program sponsored by one organization serving multiple church employers helps provide continuity and consistency of benefits for employees, including pastors who may be asked to move between small, local churches with few employees.

II. Overview of Previous Church Alliance Comments on Code Section 512(a)(6)

The Church Alliance has been pleased to have the opportunity to comment previously with respect to unrelated business taxable income

("UBTI") under Internal Revenue Code ("Code") Section 512(a)(6). This includes a comment letter submitted on December 3, 2018 in response to Notice 2018-67 detailing the potential impact of Code Section 512(a)(6) on church retirement plans and a letter submitted on June 26, 2018 requesting a delay in implementation of changes relating to Code Section 512(a)(6).

III. Investments of Church Alliance Organizations

By way of background, Church Alliance organizations receive contributions from individual churches and other ministries, and from the employees of those churches and ministries, which are deposited into tax-exempt trusts and used to pay benefits pursuant to the terms of the related employee benefit plan. Often the benefits must also be paid pursuant to rules of the denomination.

Most of these contributions are held in church retirement plan trusts, but some are held in church welfare plan trusts (disability and health plans, etc.). Because the benefits are to be paid in the future, prudence requires the plan contributions to be invested over time. Investment of the contributions in these church plans is a core part of the mission of our members to provide care for church workers and key to their tax-exempt purpose.

Prudence also dictates diversification of investments, which may include real estate and private equity. These investments tend to be pooled into more diversified funds in the form of a partnership. Thus, benefit trusts find themselves owning multiple limited partnership interests to further diversify their investments.

IV. Partnership Investments

A. Investment Activities (1.512(a)-6(c)) - Qualifying Partnership Interests, Control Test

The Church Alliance greatly appreciates the consideration given by the Agencies to help reduce the compliance burden (and cost) associated with the implementation of Code Section 512(a)(6) by allowing tax-exempt organizations to aggregate their limited partnership investments under the qualifying partnership interest (QPI) standard. The proposed regulations set forth a two-prong control test for determining whether a partnership interest is a QPI. A partnership interest is a QPI that meets the requirements of the control test if the tax-exempt organization (i) holds no more than 20% of the capital interest, and (ii) does not have control over the partnership within the meaning of paragraph (c)(4)(iii) of this section. *See* Prop. Treas. Reg. § 1.512(a)-6(c)(4)(i).

As discussed in more detail below, the Church Alliance believes that the first-prong of the control test should be increased to 50%, which is supported by the statutory language and relevant guidance. The Church Alliance is concerned that if the first-prong of the control test is not increased to 50%, the application of Code Section 512(a)(6) will impose practical compliance hurdles and infringe on a religious organization's right to invest in enterprises that advance its religious beliefs (e.g., socially responsible investing, such as investments in affordable housing). Because of the concerns described below, we recommend that the Agencies revise the control test and increase the percentage interest included in the first prong of the control test from 20% to 50%.

(i) <u>Control Test – Statutory Language</u>

The 20% percentage interest threshold used in the control test is not an appropriate standard for determining the requisite interest under Code Section 512(a)(6). Other more analogous sections of the Code support a higher threshold. The new silo rule only applies "[i]n the case of any organization with more than one unrelated trade or business . . . ." *See* Code Section 512(a)(6). Thus, the question is what does it mean to be a tax-exempt organization "with more than 1 unrelated trade or business" and, more basically, what does it mean to be an organization "with" a trade or business?

From a practical perspective, an organization would need to own a sufficient percentage of the capital interest to be carrying on the trade or business, or have sufficient control over it to be an organization "with" a trade or business. However, the Agencies have noted that Code Sections 511-514 suggest a lesser standard and that for administrative convenience a proxy for material participation might be adopted. *See* 85 Fed. Reg. 23179-23181.

We suggest instead that, since the other provisions in Code Sections 511-514 have a multitude of standards and exceptions, as noted at 85 Fed. Reg. 23179, an equally reasonable and simpler administrative standard would borrow from other sections of the Code that would work equally well as analogies for an organization "with" a trade or business, as set out below, and reduce the administrative burden and cost to tax-exempt organizations.

The Agencies suggest that a proxy for participation (or more specifically, for partnerships in which the organization does not significantly participate) is 20% of the capital interest in a partnership. *See* 85 Fed. Reg. 23181. It then cites Code Section 731(c)(3)(C)(i) and Treas. Reg. § 1.731-2(e), an isolated regulation on distributions to partners in investment partnerships, to support a 20% threshold. *Id.* The rules on distributions to partners in investment partnerships are particularly unhelpful, however, since the statute these rules interpret has language mandating that a partnership shall be treated as engaged in any trade or business under certain circumstances. *See* Code Section 731(c)(3)(C)(iv). Whereas, the provision at issue here is one that does not have any language about "treating" an organization as engaged in a trade or business under certain circumstances – it simply creates a new silo rule for organizations "with more than 1 unrelated trade or business."

Therefore, we recommend that the Agencies look to alternate statutory provisions when determining whether an organization is one "with more than 1 unrelated trade or business." *See* Code Section 512(a)(6). The Code and regulations contain various provisions defining percentage interest tests for an organization with a trade or business, usually in the context of the organization being responsible for tax or some other liability or responsibility for the business, or preventing the organization from taking excessive advantage of tax benefits through the use of multiple persons or entities.

A sufficient percentage of capital is in the range of 50% to 80%. *See* Treas. Reg. § 1.414(c)(2) (which requires an 80% interest in defining "Trades or Businesses Under Common Control" for purposes of withdrawal liability under the Multiemployer Pension Plan Amendments Act); Code Section 267(b)(2) (which sets 50% ownership as the trigger to disallow a deduction for a loss on

sale of property between an individual and a corporation); and Code Section 512(b)(13) (which uses 50% in the context of UBTI from controlled organizations).

The simplest approach would be to acknowledge that, in the absence of control as defined in Prop. Treas. Reg. § 1.512(a)-6(c)(4)(iii), a tax-exempt organization would need to own at least 50% of the capital stock or other interest in the business for it to be an organization "with" a trade or business, for purposes of the new silo rule under Code Section 512(a)(6). This increased threshold is supported by more analogous statutory provisions and IRS guidance and is a more appropriate standard for the percentage interest used when determining whether the tax-exempt organization is an organization carrying on more than one unrelated trade or business.

(ii) <u>Control Test – Practical Implications</u>

From a practical perspective, requiring a tax-exempt organization to separately account for the UBTI of a limited partnership interest solely because it holds an interest greater than 20% is extremely burdensome (and costly). The government can reduce the cost of compliance on tax-exempt organizations by increasing the percent threshold in the first prong of the control test from 20% to 50%.

Some of the complexity and cost of the lower 20% threshold arises from the fact that complete and accurate UBTI is often reported by limited partnerships to tax-exempt organizations after the original date on which the Form 990-T is due. This makes it very difficult to make timely deposits of estimated income tax as well as file an accurate extension of time to file Form 990-T (i.e., filing of Form 8868). In addition, if the appropriate tax is not paid at the time the extension application is filed, the tax-exempt organization will be subject to penalties and interest.

This issue will arise when a tax-exempt investor is not aware of the UBTI generated from a non-QPI limited partnership investment until after their extended due date, which is often the case when a partnership has also extended its tax reporting obligation. Due to Code Section 512(a)(6), the tax-exempt organization cannot offset non-QPI UBTI with the unrelated business losses generated from other QPI limited partnership investments (whether from the current year or carried forward as a net operating loss). In this situation, the potential exists that the tax-exempt organization, through no fault of its own, may be subjected to penalties for the underpayment of estimated tax and for the late payment of tax on UBTI at the time of the filing of their extended Form 990-T.

We strongly believe that from a practical compliance perspective, the control test described in Prop. Treas. Reg. § 1.512(a)-6(c)(4)(iii) should be the driving force behind the determination of whether or not a limited partnership investment should be treated as a QPI. If a limited partner does not meet any of the four discrete rights or powers set forth in Prop. Treas. Reg. § 1.512(a)-6(c)(4)(iii), and does not own 50% or more of the limited partnership, the limited partnership should qualify as a QPI. Relying on the second prong of the control test and increasing the percentage ownership threshold from 20% to 50% will allow tax-exempt investors to aggregate additional limited partnership investments, for which it has no control, as QPIs. This will significantly reduce the administrative burden and cost of tax compliance for the tax-exempt community.

(iii) <u>Impact on First Amendment and Related Concerns</u>

The Church Alliance contains members of religious organizations that invest in order to expand their ability to carry out their mission, and many invest in accordance with their religious principles[1]. Setting the threshold for triggering the silo rule as low as 20%, however, will discourage such religious organizations from more meaningful participation in investments aligned with their religious principles.

Increasing the percentage ownership threshold to 50% would reduce this infringement on a religious organization's right to meaningfully invest in limited partnerships that advance their religious beliefs (e.g., socially responsible investing, such as investments in affordable housing).

V. Additional Recommended Changes

A. Proposed Grace Period

The Agencies requested comments regarding whether permitting a higher percentage interest in taxable years in which an increase in the percent ownership of a partnership occurs as the result of actions of other partners would address concerns raised by commenters. We agree with commenters that a grace period is necessary. We recommend that if a partnership interest met the requirement of either the de minimis test or the control test, but then through no action of the tax-exempt partner, the investment fails either the de minimis or control test in a subsequent year, the partnership interest should continue to be treated as a QPI <u>through the end of the taxable year</u> following the taxable year of the transition to a non-QPI.

For example, if a tax-exempt organization invests in Partnership A on January 31, 2020 and its interest satisfies the de minimis test or control test through the end of the taxable year, but through no action of the tax-exempt organization, the percentage interest increases on November 1, 2021 so that the investment no longer meets the requirement to be treated as a QPI for the 2021 tax year, the interest in Partnership A should be allowed to be treated as a QPI through December 31, 2022.

This grace period is especially important if the Agencies will continue to require limited partners with interests of more than 20% to be treated as non-QPIs. As limited partners that are not involved in the management of the partnership, the tax-exempt organization will generally not be notified of changes in the ownership interests of other partners. The tax-exempt organization that invests as a limited partner will often not receive the information necessary to confirm its ownership interest from the partnership until after the end of the applicable tax year. If the requested grace period is not provided, the unexpected transition to a non-QPI could result in unanticipated penalties for failing to pay estimated taxes and timely filing of an application for extension of time to file. As such, we recommend that the Agencies adopt the recommended grace period described above. [2]

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[1] For example, <u>The Book of Discipline of The United Methodist Church</u>, ¶717 (2016), provides: "All United Methodist institutions shall endeavor to seek investments in institutions, companies, corporations, or funds that promote racial and gender justice, protect human rights, prevent the use of sweatshops or forced labor, avoid human suffering, and preserve the natural world, including mitigating the effects of climate change."

[2] We note that the need for any grace period would be virtually eliminated if the Agencies were to increase the percentage interest from 20% to 50% as recommended in this comment letter.

B. Addition of Capital Account Threshold to Control Test

In addition to raising the percent threshold from 20% to 50%, the Church Alliance also believes that the Agencies should establish a capital account threshold for qualification as a QPI based on the average capital account balance of the investors in the limited partnership.

Incorporating a minimum capital account threshold in the control test contained in Prop. Treas. Reg. § 1.512(a)-6(c)(4)(iii) would also help to further reduce the compliance burden (and cost) of segregating limited partnership investments and potentially reporting de minimis amounts of UBTI separately from the other QPI limited partnership investments. The Church Alliance proposes that the Agencies establish $500,000 as the capital account threshold for qualification as a QPI; such a threshold would significantly reduce compliance burden and cost.

C. Other issues

Several other issues arise, as described in the next few paragraphs, which highlight the challenges of applying 20% in the control test and supporting the application of a 50% threshold to reduce the likelihood of these issues arising. If the percent threshold is not increased, we urge the Agencies to issue guidance in these areas.

The application of such a low percentage threshold for determining whether a partnership interest is a QPI will result in fluctuations above and below the 20% threshold from year to year. Would an investment that fluctuated above 20% in any given tax year be required to be segregated for UBTI purposes for all future years even if the tax-exempt organization's ownership interest falls below 20% at some point in the future? We would hope and suggest it would not. However, if the taxpayer is allowed to aggregate UBTI relating to an investment that falls below 20% in future years with other UBTI investments, we have questions about what would happen to any net operating losses, suspended passive activity losses, and any other "deferred" tax attributes that are required to be segregated during the period when aggregation was impermissible.

Code Section 172(b)(1) provides that net operating losses may be carried forward indefinitely. In the example above, where a taxpayer's interest falls below 20% in a future tax year, would the segregated net operating loss remain suspended indefinitely or would the segregated net operating loss follow the investment and be placed into the aggregated bucket with all other UBTI generating investments? What would be the response to these questions if, in a future tax year, the ownership interest of an investment increases above 20%?

Another issue to consider is the treatment of the segregated net operating loss when the segregated limited partnership interest is divested. Will the remaining net operating loss (post-disposition of the segregated investment) be allowed to be used to offset any other UBTI of the taxpayer, whether generated within the aggregated bucket or within another segregated limited partnership? Would there be ordering rules for the use of this segregated net operating loss carryforward post-disposition of the segregated investment?

These issues and concerns surrounding the use of segregated net operating loss carryforwards also apply to all other types of tax attributes (e.g., passive activity loss carryforward, foreign tax

credit carryover, capital loss carryforward, charitable contribution carryforward, etc.). These issues and concerns weigh in favor of a 50% threshold in the control test, as opposed to the 20% threshold set forth in the Proposed Regulations.

Conclusion

Thank you for your consideration. We are happy to serve as a resource for you and your staff on these issues. I am available at (202) 778-9128 if you have any questions or wish to discuss any of the information in this letter further.

Sincerely,

Karishma Shah Page
Partner
K&L Gates LLP
On behalf of the Church Alliance