NACUBO

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June 22, 2020

Mr. Jonathan Carter
Office of Associate Chief Counsel (TEGE)
Internal Revenue Service
Washington, DC 20444

Re: <u>REG–106864–18</u>

Dear Mr. Carter:

On behalf of the National Association of Colleges and University Business Officers (NACUBO) and the undersigned higher education organizations, I am writing to offer comments in response to the April 24 notice of proposed rulemaking (NPRM) related to the implementation of Internal Revenue Code (IRC) §512(a)(6) which was added by the Tax Cuts and Jobs Act (TCJA).

NACUBO is a nonprofit professional organization representing chief administrative and financial officers at colleges and universities across the country. NACUBO's mission is to advance the economic vitality, business practices, and support of higher education institutions in pursuit of their missions.

Prior to enactment of IRC §512(a)(6), colleges and universities and other exempt organizations were able to aggregate unrelated business taxable income (UBTI) and losses and pay taxes on the net income. The computation of taxable income and loss on a net basis is the same treatment that taxable entities receive because this method accurately reflects the organization's taxable income. The new "basketing" rule of §512(a)(6), however, requires tax-exempt entities to compute taxable income separately with respect to each of their trades or businesses giving rise to UBTI. This prevents colleges and universities from offsetting the UBTI of one trade or business with the loss of another, thereby increasing the institution's overall tax burden.

We appreciate the opportunity to respond to this guidance and offer the following comments to the notice of proposed rulemaking (NPRM).

CLASSIFYING UNRELATED BUSINESS ACTIVITIES

Thank you for adopting the recommendation submitted by several commenters, including NACUBO, to require using only the first two digits of the North American Industry Classification System (NAICS) 6-digit codes for purposes of determining whether an exempt organization has more than one unrelated trade or business. This will offer straightforward reporting without creating undue confusion and burden for exempt taxpayers or the IRS.

The proposed rules prohibit the use of a single code more than once. However, we recommend that the final rules clarify how to address one activity that may include two or more NAICS codes. One example of such an activity is the rental of meeting space in a building that includes UBTI earned from space with services provided to tenants [per Treas. Reg. 1.512(b)-1(c)(5) does not constitute rent from real property] and UBTI from space that includes personal property [IRC Sec. 512(b)(3)(B) rent not excluded from UBTI]. Rental revenue tainted by services is no longer classified as real property rental per Treasury Regulations while rental revenue tainted by excessive personal property retains its character as real property rental and therefore subject to unrelated business income tax (UBIT). Additionally, space rental may violate both the service and personal property limits, in which case, it is not clear which NAICS code applies (NAICS code 53, Real Estate and Rental and Leasing, for rents tainted by personal property and/or another NAICS code for rents tainted by services, possibly 56 Admin and Support…Services). Bifurcating one activity into two or more different trades or businesses based on NAICS codes will result in an unnecessary reporting burden and will not reflect the nature of the unrelated trade or business which is one activity (rental of meeting space). Reporting all revenue streams under one primary NAICS code (or allowing Schedule M to reflect two or more NAICS codes) will better reflect the substance of the unrelated business activity in its entirety.

ALLOCATION OF EXPENSES

In keeping with the example provided above, the final rules should allow the unadjusted gross to gross allocation method if there is no price difference for goods/services provided to members (related activity) vs. non-members (unrelated activity)**.** It is not reasonable to disallow use of the gross-to-gross allocation method if there is no need to adjust for price differences and it reasonably allocates expenses between the UBI and related activities.

REPORTING OF INVESTMENTS

We are also grateful that Treasury and the IRS have recognized that a tax-exempt organization's investment activities should be grouped together for purposes of IRC Section 512(a)(6). Based on the proposed regulations, the investments basket is comprised of qualified partnership interests (QPIs), debt-financed properties, and underlying S corporation interests.

Under the proposed rules, as under Notice 2018-67, a partnership interest will be a QPI if it meets either a *de minimis* test or a control test. No partnership in which the organization or institution is a general partner may be a QPI. The 2% de minimis test is straightforward, and we thank the Service for eliminating the requirement proposed in Notice 2018-67 to take into account holdings of other persons when calculating the institution's percentage interest in the partnership.

The NPRM proposes that an organization or institution meets the control test if i) it does not hold more than 20% of the capital interests in the partnership and ii) does not control the partnership based on facts and circumstances. We thank the Service for removing the additional requirement proposed in Notice 2018-67 that organizations aggregate its holdings with interests held by disqualified persons, such as officers, directors, and trustees.

According to the preamble, policymakers "recognize that exempt organizations have UBTI under sections 511 through 514 from activities engaged in with an intent to make an investment rather than with the intent to actively participate in any of the unrelated trade or business activities generating the UBIT." In light of that recognition, we strongly reiterate our recommendation that for the reporting of UBTI from investments, the percentage threshold for a control test for ownership in a partnership (which serves as a proxy to identify partnership interests in which the tax exempt organization does not significantly participate[1]) should be greater than 50 percent, rather than the 20 percent proposed in the NPRM. While the percentage ownership in a partnership – as opposed to status as a limited partner or general partner – does not have a bearing on whether the tax-exempt partner significantly participates in or actively manages the operations of a partnership, we recognize Treasury and the IRS are focused on a bright line test for this part of the control test.

It would be uncommon for a limited partner – even one owning in excess of a 20% or a 50% interest in the partnership – to significantly participate in any trade or business of the partnership. Though, as mentioned above, the IRS and Treasury are using the percentage test

[1] The preamble to the proposed regulations states that it will retain the 20 percent threshold used in Notice 2018-67. *The Treasury Department and the IRS intend the percentage threshold to be a proxy to identify partnership interests in which the exempt organization does not significantly participate in any partnership trade or business and therefore may appropriately be considered an investment activity for purposes of section 512(a)(6).*

as a proxy for significant participation, the threshold for control is higher in other contexts applicable to tax-exempt organizations. For example, section 512(b)(13) defines "control" as 50% in the case of a partnership. The instructions to Form 990, Schedule R, page 2 define control of a partnership or limited liability company as existing if a tax-exempt organization owns "more than 50% of the profits interest or capital interest in the partnership (including a limited liability company treated as partnership or disregarded entity for federal tax purposes, regardless of the designation under state law of the ownership interests as stock, membership interests, or otherwise)."

The adoption of a 50% threshold provides the same bright line test that a 20% threshold provides and would serve to reduce the administrative burden both on the organization and the Service by allowing a greater number of investments of a tax-exempt organization to be grouped in the investments basket.[2] **We therefore strongly urge the Service to adopt as part of the control test a greater than 50%, rather than the 20% threshold included in the proposed regulations.**

Unlike the de minimis test, the proposed regulations do not permit a tax-exempt organization to look-through directly held partnership interests for purposes of applying the control test. Consistent with the intent of IRC Section 512(a)(6), we request the tax-exempt organization be allowed to look through any directly or indirectly held partnership interest to determine whether the % ownership test is satisfied with respect to the underlying partnership interest generating UBTI.

In the absence of a look-through rule, tax-exempt organizations will be required to group UBTI generated by underlying pass-through entities (such as lower-tier partnerships) into separate NAICS Codes if the directly owned partnership does not satisfy the control test. Not only would this requirement be needlessly onerous, but it could result in inconsistent treatment of a partnership interest and its UBTI based solely on whether it is held directly or indirectly rather than based on its relationship to the tax-exempt investor. For example, a tax-exempt organization directly owns 12% of limited partnership A. Because it satisfies the control test, limited partnership A is considered a QPI and any UBTI will be included in the investments basket. However, if instead the tax-exempt organization directly owns 60% of limited partnership B, which in turn owns 20% of limited partnership A, the UBTI generated by limited partnership A in which the tax-exempt organization holds an indirect 12% interest will be excluded from the investments basket and will be grouped based on NAICS Codes due to the fact that limited partnership B fails to satisfy the control test.

[2] Despite incorporating more investments into the investment activities basket, it would still exclude some of the tax-exempt organization's bona fide investment activities from the investment activities basket.

It seems unproductive to task directly owned partnerships that do not satisfy the control test with disclosing every NAICS Code activity of the lower-tier pass-through entities, particularly when if held directly they would likely satisfy the control test and be considered investment activities. Furthermore, because the manager of the partnership knows the partnership percentages of the underlying partnership (in order to report allocable shares of UBTI), it will not be a significant administrative burden to report the underlying partnership percentage, which will enable the tax-exempt organization to confirm that its interest satisfies the control test on a look-through basis. **Therefore, similar to the de minimis test, we urge you to apply the look-through rules under proposed regulation 1.512(a)-6(c)(2)(ii) to indirect partnerships that meet the control test, and those interests should be allowed to be aggregated with the directly held QPI interests.**

Thank you for the opportunity to share our suggestions with you as you continue to develop guidance implementing the TCJA and welcome communications between our organizations as you continue to work on provisions affecting colleges and universities. Please contact Mary Bachinger, director of tax policy at mary.bachinger@nacubo.org.

Sincerely,

Susan Whealler Johnston
President and Chief Executive Officer

On behalf of the following associations:

American Association of Community Colleges
American Council on Education
Association of American Universities
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Association of Public and Land-Grant Universities
Council for Advancement and Support of Education
Council for Christian Colleges and Universities
National Association of Independent Colleges and Universities
United Negro College Fund, Inc.