National Association of College and University Business Officers
1110 Vermont Avenue, NW, Suite 800, Washington DC 20005-3544
T 202.861.2500 F 202.861.2583
www.nacubo.org

November 30, 2018

Ms. Stephanie N. Robbins
Mr. Jonathan A. Carter
Office of Associate Chief Counsel (TEGE)
Internal Revenue Service
CC:PA:LPD:PR (**Notice 2018-67**)
Room 5208
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Dear Ms. Robbins and Mr. Carter:

On behalf of the National Association of Colleges and University Business Officers (NACUBO) and the undersigned organizations, I am writing to offer comments in response to Internal Revenue Service Notice 2018-67 (the Notice), 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 more than 1,900 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 trade or business 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 are grateful for the opportunity to respond to this guidance implementing the basketing requirement and offer the following comments to the Notice:

Section 3. Identifying Separate Trades or Businesses. The Treasury Department and the Internal Revenue Service (IRS) are considering the use of 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 for purposes of §512(a)(6). Comments have been requested regarding whether using fewer than 6 digits of the NAICS codes, or combining NAICS codes with other criteria, would appropriately identify separate trade or businesses for purposes of achieving the objective of §512(a)(6). In addition, the Notice requested comments on the utility of this method, other methods, or a combination of methods that could be used for making this determination.

As discussed below, we recommend using the trade or business codes identified in IRS Form 14018 rather than the NAICS codes or, in the alternative, use only the first two digits of the NAICS codes.

Discussion and Recommendations. **The 2017 NAICS manual consists of 963 pages of detailed classification codes, yet they do not include codes clearly describing many common university activities that generate unrelated business taxable income.**

Requiring use of 6-digit NAICS codes will result in singular activities, such as food service, being separated into multiple trades or businesses. The NAICS codes are both over- and under-inclusive and, therefore, not suitable for this purpose.

For example, a university food service operation often consists of the following components:

722515 Snack and Nonalcoholic Beverage Bars
722513 Limited Service Restaurants
722514 Cafeterias, Grill Buffets, and Buffets
722511 Full Service Restaurants

At a typical university, these operations would be managed and/or conducted by one business unit and thus should all be classified as one trade or business for purposes of §512(a)(6). Yet the NAICS codes suggest that they are separate trades or businesses.

Recreational activities are another example of activities managed and/or conducted by one business unit of a college or university that would require separate computation if 6-digit codes are used:

713940 Fitness and Recreational Sports Centers
713910 Golf Courses and Country Clubs
713950 Bowling Centers

Moreover, the more granular the definition trade or business becomes, the more time-consuming and burdensome the preparation of an accurate UBI return becomes, diverting resources from an institution's mission. **It is common for colleges and universities to account for related and unrelated activity in a single accounting entity.** Within that single accounting entity, colleges and universities separate out the related and unrelated revenue streams for each trade or business, then review the activities further for any potential exemptions from UBI. For example, only a small fraction of revenue from general business operations is unrelated because it primarily fulfills a university's exempt purpose.

Further, we note that a report issued by the Treasury Inspector General for Tax Administration (TIGTA) on July 17, 2014 (the TIGTA Report),[1] concluded that NAICS codes are "unreliable" for use in identifying businesses that may be subject to excise tax reporting and payment, because a single activity may be described using several different codes, while a single code may indicate several different activities. If NAICS codes are unreliable for excise tax purposes they may well be similarly unreliable for unrelated trade or business identification purposes. The TIGTA Report points out that source of unreliability for this system of coding is the variety of codes that are available, which leads businesses to inconsistently select codes. Using such a system for UBIT reporting could also lead to inconsistent reporting of similar activities among organizations.

Additionally, such codes are subject to periodic change by NAICS. Changes in code numbers would create confusion and inconsistent reporting from year to year and the possible inaccurate conclusion that a trade or business activity may have changed, when only the designated code for that activity has changed.

We recommend using the first two digits of the NAICS classification system as a safe harbor basis for identifying separate trades or businesses rather than 6 or even 4 digits which are too narrow. The first two digits of the NAICS classification system

[1] "The Affordable Care Act: An Improved Strategy is Needed to Ensure Accurate Reporting and Payment of the Medical Device Excise Tax," Treasury Inspector General for Tax Administration, July 17, 2014 (Ref. No. 2014-43-043), available at https://www.treasury.gov/tigta/auditreports/2014reports/201443043fr.pdf.

identify the industries associated with business establishments. In a majority of college and university settings, the unrelated trade or business lines have common oversight and work jointly on an industrial basis. For example, NAICS Industry code 44-45 “Retail Trade” would typically have common managers and reporting responsibilities among the business lines. Internal reporting for the different storefronts would consolidate into one “Retail Trade” accounting report for results and planning purposes. Use of the two-digit Industry Codes as a safe harbor for purposes of §512(a)(6) would be less likely to have subjective interpretation or confusion by both tax-exempt organizations and the IRS, as well as minimize implementation costs for all entities with separate unrelated trades or businesses and keep the administrative process for the Service manageable. The first two digits are also less likely to change over time than the four- or six-digit codes are.

We do not recommend including the institution’s investment activities as passive investors managing the institution’s investment portfolio in the NAICS system. Our expanded recommendations related to investments appears later in this document.

An alternative to the NAICS classification system that we commend to you for consideration are the activity categories used in IRS Form 14018, Compliance Questionnaire Colleges and Universities. Part II of the questionnaire contained 30 activities grouped in four general categories including advertising, corporate sponsorships, rentals, and Other (catalog sales, internet sales, travel tours, broadcast rights, affinity cards, mailing list rentals, logo usage, etc.) which represent most of the activities generating UBI on college campuses. These 30 activities derive from the IRS’s own information about the common sources of UBTI for colleges and universities and are therefore a much better proxy for UBTI among tax-exempt organizations in general than are the NAICS codes. Using the Form 14018 categories and activities as a safe harbor would reduce compliance costs for both taxpayers and the IRS.

Section 3.04 – Allocation of Directly Connected Deductions & Section 8.02 – Fringe Benefits. **We recommend clarification that deductions for certain expenses not attributable to a trade or business such as charitable contributions can be used to offset UBTI that is not separately computed under §512(a)(6), including the tax on qualified transportation fringe benefits under §512(a)(7).**

IRC §512(a)(1) permits an exempt organization with an unrelated trade or business to reduce the income from that trade or business by the deductions allowed by Chapter 1 of the Code that are directly connected with the carrying on of such trade or business, computed with the modifications provided in §512(b).

IRC §512(b)(10) states, “In the case of any organization described in §511(a), the deduction allowed by §170 (relating to charitable etc. contributions and gifts) shall be

allowed (whether or not directly connected with the carrying on the trade or business), but shall not exceed 10 percent of the unrelated business taxable income computed without the benefit of this paragraph." (emphasis added).

Since charitable contribution deductions are deductible "whether or not directly connected with the carrying on the trade or business," it stands to reason that such deduction should not be subject to §512(a)(6). Additionally, since §512(b)(10) states that it will not exceed 10 percent of the unrelated business taxable income, and §512(a)(7) is an increase to unrelated business taxable income, the charitable deduction should apply to the total unrelated business taxable income after combining all §512(a)(6) and §512(a)(7) amounts. The deduction for an organization's charitable contributions, therefore, should be able to offset the §512(a)(7) UBIT inclusion.

We recommend that deductions for tax preparation fees can be used to offset both UBTI that is separately computed under §512(a)(6) and also UBTI that is not separately computed, including the tax on qualified transportation fringe benefits under §512(a)(7).

Tax preparation fees—both internal and external—are attributable both to the UBTI separately computed under §512(a)(6) as well as to the UBTI increase for qualified parking and transportation fringe benefits under §512(a)(7). It should, therefore, be able to offset UBTI from any source. The deduction for tax preparation fees is particularly important in the context of the §512(a)(6) rules as exempt institutions are likely to have increased tax preparation fees in the coming years due to the need for assistance complying with the TCJA. Allocating tax preparation fees to certain trades or businesses would not be reasonable since the work relates to all of the entity's activities and should therefore apply to all unrelated business taxable income after it has been calculated under §512(a)(6) and combined with §512(a)(7) income.

Similarly, state income taxes not directly connected with carrying on a separate trade or business should be allowed to reduce UBTI from any source, including UBTI from separate trades or businesses under §512(a)(6) and §512(a)(7) income. Some institutions may be filing a form 990-T and applicable state returns for the first time, solely because of the §512(a)(7) increase to UBTI. State tax expenses associated with the state income tax filings should be deductible against §512(a)(7) income because they are clearly directly connected with this increase to UBTI.

Finally, while the Notice did not address tax credits and the TCJA only addresses changes to revenue and expenses for UBTI, we recommend that future guidance provide that any applicable credits will continue to apply as provided elsewhere in the IRC.

We recommend a per-employee cap on §512(a)(7) UBIT. One interpretation of the new §512(a)(7) UBTI provision is that the expense pick-up for UBTI purposes is capped at the §132(f) amount of $260 (as adjusted for inflation) per month per employee pre-tax deduction.[2] It would be appreciated if the IRS could confirm this and include it in any guidance.

Section 5. Activities in the Nature of Investments. The Notice states that the Treasury Department and IRS intend to propose regulations that treat "investment activities" as one trade or business. Additionally, the Notice requests comments regarding the scope of the activities, both investment partnership interest and other activities in the nature of an investment that may generate unrelated business income, that constitute the single trade or business of "investment activities."

First, we note that the definition of "trade or business" for purposes of UBIT in IRC §513(c) does not include "investment activities." Rather, it only includes activity "carried on for the production of income from the sale of goods or the performance of services." As such, it would be inappropriate for regulations to treat different types of investment as different trades or businesses. Indeed, it is unclear whether IRC §512(a)(6), which only applies to UBTI from a "trade or business," requires separate computation of investment income whatsoever.

If forthcoming guidance does require separate computation of investment income under IRC §512(a)(6), then NACUBO agrees that investment activities should be treated as one trade or business and income generated through partnership investments should be included in this category.

Colleges and universities have endowments and other funds that must be managed prudently, taking into account diversification, preservation of purchasing power, long-term stability and support for the institution. Endowments are critical for student financial aid (scholarships); they also provide important funding sources for faculty, libraries, laboratories, student services, and other components that are key to a student's education. They are managed to provide a steady, long-standing, reliable funding source over the long term, for both current and future students.

In discharging this fiduciary responsibility, many institutions invest with professional, third-party investment managers. In the world of institutional investments, partnerships (and other entities that are treated as partnerships for US federal tax purposes, such as many limited liability companies (LLCs)) are a ubiquitous form of establishing those relationships. In the investment partnership context, the institution is

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[2] The 2018 §132(f) qualified parking and transportation fringe benefit is $260 per month per employee. Section 3.17, Rev. Proc. 2017-58, 2017-45 IRB 489, 10/19/2017

generally a *limited partner*, holding a passive economic interest in the partnership, while the investment sponsor serves as the *general partner* and engages in the day-to-day operations of the partnership.

The Notice acknowledged the limited and passive role of an investor in an investment partnership by stating that the Treasury Department and IRS are concerned that using the material participation standards of IRC §469 to determine whether an investment partnership interest may be treated as an investment activity (and aggregated together with other investment activities) for purposes of §512(a)(6) may require a more extensive and complicated analysis than necessary. However, the Notice then provides interim provisions containing ownership and control tests that may well prove to be more complicated than the material participation standards. For example, the ownership test complicates matters by requiring organizations to take into account the investment holdings of disqualified persons (borrowing a concept from §4943, a Code section that does not apply to universities or other public charities) and supporting and controlled entities. The control test complicates matters as well by requiring all facts and circumstances relating to each investment partnership to be considered.

Section 6. Interim and Transition Rules for Partnership Investments.[3] Despite the stated intention in Notice 2018-67 of treating "investment activities" as one trade or business, the IRS provided an interim rule and a transition rule that require an investment-by-investment analysis and are likely to result in an institution's portfolio of partnership investments being treated as multiple separate trades or businesses for purposes of §512(a)(6).

In response to the IRS and Treasury Department's request for a standard that would define the scope of an organization's investment activities, NACUBO strongly suggests that all investments in partnerships as a limited partner be treated as a single activity, or alternatively stated as a "single basket" – to carve out any limited partner interests, or to carve activities within a partnership into multiple categories will place dramatic and undue burden on institutions, investment partnerships, and the IRS. However, if the IRS does not agree to a single basket concept for all investment activities as a limited partner, NACUBO requests that the IRS make modifications, as noted below, to the transition and interim rules.

Please note that in general, throughout this discussion, references to interests as a limited partner are intended to encompass equivalent interests in limited liability companies and non-US entities treated as partnerships for US federal tax purposes.

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[3] This recommendation applies to limited liability corporations and similar investment structures under non-U.S. law.

Transition Rule

Partnerships are often organized such that one fund may invest in a number of lower-tier partnership entities, such as portfolio companies that are treated as partnerships for US federal tax purposes, rolling up to the top tier fund. As a result, the unrelated business income that is reported by the top tier fund may be derived from many different lower level entities that may conduct a variety of unrelated businesses. Prior to the TCJA, institutions could aggregate all gains, income, and losses from unrelated trade or business activities and were not required to specifically identify the source of the unrelated business income or loss. As a practical result, institutions were able to use the information that was provided by the top tier partnership on the Form 1065 (K-1) in order to complete the Form 990-T, Exempt Organization Business Income Tax Return.

Under the TCJA, §512(a)(6) provides that when an exempt organization has more than one unrelated trade or business, unrelated business taxable income shall be computed separately. The transition rule allows an organization to treat a single partnership interest as comprising a single trade or business even if there was more than one trade or business conducted either directly or indirectly by the partnership or lower-tier partnerships if the partnership interest was acquired prior to August 21, 2018.

Requiring institutions to look through tiered partnerships to separately report unrelated business income from each lower-tier partnership in which an investment fund holds an interest is likely to create practical difficulties for institutions. As a limited partner, the institution has very limited knowledge of the operations of the fund or of lower-tier partnerships in which the fund may hold an interest. Institutions would need to obtain this detailed data about the fund's trade or business activities from the investment partnership itself. While partnerships are required to provide to their tax-exempt partners the information necessary for those partners to determine their UBTI, requiring this level of detail would place a new financial burden on the partnership with the possible result that the investment vehicles would either stop admitting charitable institution partners, or alternatively charge significant fees to charitable institution investors to comply with new reporting requirements.

In addition to both the financial and practical burden that would result from a requirement for lower-tier partnerships income to be reported as separate trades or businesses, it would also create a considerable administrative headache for the IRS in examining Form 990-Ts of organizations that hold partnership investments.

The transition rule described in the Notice permits institutions to treat each partnership investment as a single "basket," thus avoiding the substantial expense and administration burden described above with respect to transition-rule eligible investments. However, the transition rule does not apply to any investment made on or

after the date of the Notice. **Therefore, if the IRS and the Treasury Department do not adopt NACUBO's recommendation to permit all limited partner interests in partnerships to be treated as investment activities, subject to further treatment as a single trade or business activity, NACUBO recommends, at a minimum, extending the transition rule to apply to all partnership interests, whether or not acquired before a particular date.**

Interim Rule

The interim rule requires the organization to apply a *de minimis* test and a control test to determine how to aggregate partnerships. The 2% *de minimis* test is clear, though as noted above, it requires an organization to take into account holdings of other persons when calculating the organization's percentage interest in the partnership. To satisfy the control test, the exempt organization must directly hold not more than 20% of the capital interest, as well as establish based on all the facts and circumstances that it does not control the partnership.

However, there is uncertainty about how the basket would be maintained over time as ownership interest changes. Often an investment in an initial year is intentionally small, in order to limit the risk in a potentially unknown venture. As the investment vehicle proves itself over time, additional contributions may be made, increasing the ownership percentage. Indeed, over time the ownership percentage in any given partnership may change from less than 2% to greater than 20%. Further, the ownership percentages may change with no action on the part of the partner, such as when other partners enter or exit the partnership.

Considering that partnership ownership levels may fluctuate, to facilitate consistency in year-to-year reporting, we recommend that the investment continue to be reported in the same category or "basket" in which it is first reported (and not be required to change "baskets" due to fluctuations in control that may occur over time).

The control test looks to facts and circumstances to determine if an organization has control or influence over a partnership and states that an organization has control or influence over a partnership if it can require, or prevent, a partnership from performing an act that substantially affects the operations of a partnership. However, it would be uncommon for a limited partner – even one owning substantially in excess of a 20% interest in the partnership – to have control and the threshold for control is higher in other contexts applicable to tax-exempt organizations.

The instructions to Form 990, Schedule R, page 2, for example, 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 a 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)." **Therefore, we suggest that the percentage threshold in the interim rule control test be greater than 50%, rather than the 20% contained in the Notice.**

As discussed above, regardless of percentage ownership, tax-exempt organizations often have no significant control over the operations of investment partnerships since, generally, institutions invest in partnerships as a limited partner. Limited partners are typically viewed by the IRS as not being material participants in the business, therefore rendering the income as passive income. Although in some states, a limited partner may be able to vote on basic issues such as removing a general partner in certain extraordinary circumstances, the limited partner does not control management of the partnership's operations and, indeed, may risk losing its status as a limited partner for state law purposes, thereby losing its claim to limited liability for the obligations of the partnership. Several institutions have indicated that although they can make suggestions to a partnership as a limited partner, the partnership has no obligation to comply with the limited partner's request. **Therefore, in addition to our request that the control test be based on a greater than 50% ownership rule, we also request that institutions holding interests as limited partners be rebuttably presumed not to have control or influence over the partnership, such that limited partnership interests would pass the control or influence portion of the stated control test absent evidence that the institution controlled the partnership notwithstanding its purported limited partner status.**

Certainly, if an organization were an active participant in a partnership, the organization would likely have more knowledge of the underlying activity within the partnership. However, most institutions are not actively involved in partnership activities.

If the transition rule were altered as recommended to extend its application to all partnership investments, and the control test were altered to treat all limited partnership interests as included in a single trade or business absent greater than 50% ownership interest and evidence that the institution controlled the partnership, the spirit of the rule would be retained, namely, to ensure that institutions are unable to offset losses from one trade or business against income from another trade or business. Further, it would avoid the considerable administrative drain that would result from institutions having to obtain and analyze detailed information on potentially hundreds of partnerships.

Conclusion. **To summarize, NACUBO recommends:**

- **that investment activities of an institution be defined to include all investments as a limited partner in a partnership, such that all such investments can be included in a single basket for purposes of §512(a)(6). If this recommendation is not adopted, as an alternative, NACUBO recommends that the transition rule provided in the Notice be extended to apply to any partnership interest, not only those acquired before the date of the Notice.**

- **that the interim rule be modified to permit tax-exempt organizations to include all partnership investments in a single trade or business to the extent the organization owns 50% or less of the capital and profits interests in the partnership; and**

- **that limited partnership interests in excess of 50% of the capital or profits interests in a partnership be presumed to be included in the same single trade or business, absent evidence the organization actually controls the operations of the partnership.**

We are grateful for the opportunity to share our suggestions with you as you continue to develop guidance implementing the TCJA and welcome communication between our organizations as you continue to work on provisions affecting colleges and universities. Please contact Mary Bachinger, director of tax policy, at 202-861-2581, mary.bachinger@nacubo.org or Liz Clark, senior director of federal affairs, at 202-861-2553, liz.clark@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 Public and Land-Grant Universities
Council for Advancement and Support of Education
National Association of Independent Colleges and Universities

cc:
<u>Treasury:</u>
David Kautter, Assistant Secretary for Tax Policy
Stephen LaGarde, Attorney-Advisor, Office of Benefits Tax Counsel
Elinor Ramey, Attorney-Advisor, Office of Tax Policy

<u>Internal Revenue Service:</u>
Robert Choi, Acting Deputy Commissioner
Janine Cook, Deputy Associate Chief Counsel, Tax Exempt & Government Entities
David Horton, Acting Commissioner for Tax Exempt & Government Entities
Victoria Judson, Associate Chief Counsel, Tax Exempt & Government Entities
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel
Charles Rettig, Commissioner
Drita Tonuzi, Deputy Chief Counsel for Operations