July 29, 2020

Ms. Melinda Williams
Office of Chief Counsel (EEE)
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Ms. Amber MacKenzie
Office of Chief Counsel (EEE)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

**RE: Notice of Proposed Rulemaking Regarding Guidance on the Determination of the Section 4968 Excise Tax Applicable to Certain Private Colleges and Universities [REG 106877-18]**

Dear Ms. Williams and Ms. MacKenzie:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to address the need for guidance related to section 4968[1] as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA).

On July 3, 2019, Treasury and the IRS issued Notice of Proposed Rulemaking Regarding Guidance on the Determination of the Section 4968 Excise Tax Applicable to Certain Private Colleges and Universities [REG-106864-18] (the "proposed regulations") that impose an excise tax on the net investment income of private colleges and universities. Previously, the IRS had issued Notice 2018-55 in June of 2018. This letter is our response to the request for feedback on the rules described in the proposed regulations.

Specifically, the AICPA provides recommendations on the following issues:

I. Basis for Calculating Gains to Include in Net Investment Income, Partnership Investments

II. Basis for Calculating Gains to Include in Net Investment Income, Donated Assets

III. Exempt Use Assets

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

The AICPA is the world's largest member association representing the CPA profession with more than 431,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our comments. If you have any questions, please contact Jennifer Becker Harris, Chair, AICPA Exempt Organizations Taxation Technical Resource Panel, at (425) 454-4919, or jharris@clarknuber.com; Elizabeth Young, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (612) 397-3071, or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
Ms. Amber Salotto, Attorney Advisor, Department of the Treasury
Ms. Tamera Ripperda, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service
Mr. Edward Killen, Deputy Commissioner, Tax Exempt and Government Entities, Internal Revenue Service
Ms. Janine Cook, Deputy Associate Chief Counsel, Employee Benefits, Exempt Organizations and Employment Taxes, Internal Revenue Service
Ms. Margaret Von Lienen, Director, Tax Exempt and Government Entities, Internal Revenue Service
Mr. Stephen B. Tackney, Deputy Associate Chief Counsel, Employee Benefits, Exempt Organizations, and Employment Taxes, Internal Revenue Service

**AMERICAN INSTITUTE OF CPAs**

**Notice of Proposed Rulemaking Regarding Guidance on the Determination of the Section 4968 Excise Tax Applicable to Certain Private Colleges and Universities [REG 106877-18]**

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## BACKGROUND

Section 4968 imposes a 1.4% excise tax on the net investment income of private colleges and universities with at least 500 tuition-paying students and non-exempt use assets with a value at the close of the preceding year of at least $500,000 per full-time student. The proposed regulations under section 4968 clarify the calculation of net investment income as well as provide for a one-time step-up to fair market value (FMV) for assets that were held on December 31, 2017. The proposed regulations provide additional guidance in terms of the items included in net investment income with respect to related organizations and how to determine an institution's basis in the property it holds.

## SPECIFIC COMMENTS

### I. Basis for Calculating Gains to Include in Net Investment Income, Partnership Investments

Overview

The proposed regulations provide that, for purposes of determining net investment income under section 4968, which includes capital gain net income, the basis of an asset held by a partnership (including through one or more tiers of partnerships) (i.e., its "inside basis") held continuously since at least December 31, 2017, will not be less than the FMV of such asset on December 31, 2017 (as adjusted by the general basis rules)[2]. For an applicable educational institution (AEI) to take advantage of this rule, the proposed regulations require the AEI to "obtain documentation from the partnership to substantiate the basis used."[3]

Recommendation

The AICPA recommends that Treasury and the IRS provide final regulations that remove the documentation requirement and instead, allow an AEI to use any reasonable method to calculate the amount of its reportable gain after the step-up in basis of the assets as of December 31, 2017.

[2] Treas. Reg. § 53.4968-1(b)(3)(iv).
[3] Treas. Reg. § 53.4968-1(b)(3)(iv).

Analysis

One area of concern in the proposed regulations is the administrative difficulty of determining the basis of assets held by partnerships (including through one or more tiers of partnerships) that are owned by an AEI due to reliance on partnerships to provide timely information. To properly calculate its net investment income, an AEI would require the following information:

- The FMV of each asset owned by a partnership and all lower-tier partnerships, as of December 31, 2017;
- Asset-by-asset sale information from all partnerships and lower-tier partnerships each year. This information is necessary because as the assets held on December 31, 2017 are sold, the AEI would need to know the amount of the gain or loss reported by the partnership and all lower-tier partnerships that relates to the sale of those specific assets in order to adjust the information reported on the Schedule K-1; and
- The amount of the Unrelated Busines Income (UBI) reported by the partnership that relates to post-December 31, 2017 appreciation, in order to be able to exclude the amount from the net investment income calculation.

Obtaining this information will be administratively burdensome for partnerships and impractical as the requirement will apply to only a handful of taxpayers rather than all partnership members. Partnerships typically charge partners when additional tracking is required; therefore, requiring the partnerships to provide this information would create additional expense for the AEI.

Existing rules require a partnership to provide sufficient information on Schedule K-1 to enable each partner to calculate taxable income with respect to its partnership interest. Not all partnerships, in particular, lower-tiered partnerships, are aware that an AEI owns a direct or indirect interest and, therefore, may not supply enough information to upper-tier partnerships to allow the AEI to calculate its net investment income. In such cases, an AEI would require additional information from a directly held or indirectly held partnership, which would be time-consuming to gather. Moreover, depending on the number of lower-tier partnerships, the information would be difficult to provide.

In addition, AEIs have the ability to determine their outside built-in gain in a partnership interest as of December 31, 2017. In most cases, this outside built-in gain should approximate an AEI's share of built-in gain for underlying assets held by the partnership as of December 31, 2017. For such reasons, an AEI should be permitted, on a partnership-by-partnership basis, to calculate the amount of its outside built-in gains as of December 31, 2017 and use such amount to offset any inside gain recognized by the partnership and reported on Schedule K-1 after December 31, 2017. This approach is administratively practical and is consistent with the statutory language.

## II. Basis for Calculating Gains to Include in Net Investment Income, Donated Assets

Overview

Section 4968(c) provides that net investment income is determined under rules similar to the rules of section 4940(c). Section 4940(c)(1) generally provides that net investment income is

determined under the principles of subtitle A. Subtitle A includes all income tax provisions (sections 1 through 1564). Specifically, the basis rules in section 1015 provide that the basis of property acquired by gift is the donor's basis.

Treasury Reg. § 53.4940-1(e)(2)(iii) provides that "[i]f the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to a donee private foundation, then the original basis to such foundation of such property shall be determined under Treas. Reg. § 1.1015-1(a)(3)." Treasury Reg. § 1.1015-1(a)(3) provides a procedure for the IRS to determine the tax basis in the hands of the donor. If the IRS cannot obtain this information, then the donor's basis is deemed to be the FMV of the property, as determined by the IRS, as of the date or approximate date at which, according to the best information the IRS is able to obtain, such property was acquired by the donor.

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations permitting an AEI to use FMV as basis in instances where donor basis has been requested, but not provided by the donor, similar to Treas. Reg. § 1.1015-1(a)(3). In addition, Treasury and the IRS should revise Treas. Reg. § 1.1015-1(e) to state that the FMV for gifts received by an exempt organization is deemed to be the FMV as reasonably determined by the charity.

Analysis

The reporting of donor basis to recipient AEIs is not currently required. When the donor basis is provided, the information is submitted on Form 8283, *Noncash Charitable Contributions*. Further, when donors are required to obtain a signature from the gift recipient on Form 8283, they are not required to include the basis or FMV information on the form when presenting it for signature. Donors do not always know their tax basis in the property.

As an administratively practical approach, the burden should shift to the AEI to make reasonable efforts to obtain a donor's tax basis information prior to using FMV. Distributing a questionnaire to donors prior to April 15th of the year following the donation is an example of a reasonable effort. The questionnaire could include the donor's name, description of the donated property, date the property was acquired, tax basis, blank lines for donor's signatures and signature dates. Section 4940 and section 1015 provide for the use of FMV as the property basis when the donor's basis is unable to be determined. Thus, this method is not inconsistent with the overall statutory construction of section 4968.

## III. Exempt Use Assets

Overview

Section 4968(c) references the rules of section 4940(c) in determining the amount of income to include in net investment income (including income from interest, dividends, rents and similar sources). Section 4940(c) does not provide an exclusion from net investment income for revenue from assets used for charitable purposes.

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations excluding income from student loans and rental of housing to students and faculty of the institution from the definition of net investment income for purposes of section 4968.

Analysis

The background section of the proposed regulations suggests that interest on a student loan may be distinguished from investment income depending on the interest rate, with a rate at market or higher indicating an investment-type asset. A rate substantially below market suggests that the loan is similar to a scholarship from the school to the student.

It is overly burdensome on the IRS and AEIs to monitor market rates of interest on student loans, which change frequently. Further, an AEI would be required to use judgment with respect to the amount of a discount from the market rate they would have to offer to qualify its loans having a rate substantially below market. This judgment-based methodology would be burdensome for the IRS to regulate, even with its ability to review the matter one or more years after the AEI set its interest rate(s) for the various loans it offers.

While section 4940(c) does not provide for an exception from net investment income for program-related revenue of interest, dividends, rents and similar items, AEIs are inherently different from private foundations. Including student loan interest and institution-provided housing revenue in the definition of net investment income assumes the income is passive and investment-related in nature. By relying on the "similar to the rules of section 4940(c)" reference, regulations could allow for exceptions to inclusion in net investment income for interest, rent and similar revenue, which is generated by program activities rather than investment activities.

In addition to the distinguishing factors noted above, the IRS and Treasury have inquired as to whether certain factors related to institution-provided housing, such as the lack of a formal lease and the provision of meals, sufficiently distinguish the income from other rental income that AEIs may receive. With respect to housing arrangements, the proposed regulations state that real estate used in an AEI's exempt purpose is considered to be an exempt-use asset.[4] The real estate is primarily intended to provide students and faculty with living space within the college community, not to generate investment income from the real property. Further, the housing activity is generally not of a passive nature similar to that of many traditional rental arrangements. Each AEI must provide food, health, security, and other supporting services to its residents that many lessors in traditional rental arrangements do not provide. It is widely believed by the higher education community that after allocating expenses, the institution provided housing activity generally results in a net loss as the purpose is to fulfill charitable purposes.

Further support for excluding charitable use assets from section 4968 calculations is evident in Congress's exclusion of these assets in calculating the $500,000 per student threshold for section 4968(b)(1)(D). Therefore, excluding the income from such assets in calculating net investment

[4] Proposed Reg. § 53.4968-1(a)(4)(ii)(B).

income is consistent with Congressional intent to impose the excise tax only on excess non-charitable use assets.