

November 8, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable William M. Paul
Principal Deputy Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Messrs. Kautter and Paul:

We are writing in response to the request for comments related to Public Law 115-97, the tax law enacted last year commonly known as the Tax Cuts and Jobs Act (the “Act”). This letter will address the provision of the Act that created Section 4968 of the Internal Revenue Code (the “Code”),¹ which imposes an excise tax on the investment income of certain private colleges and universities.

Section 4968 imposes a 1.4 percent excise tax on the net investment income of each “applicable educational institution” for a taxable year. An applicable educational institution is an eligible educational institution as defined in Section 25A, which: (1) has at least 500 tuition-paying students; (2) more than 50 percent of which are located in the United States; (3) is not described in Section 511(a)(2)(B); and (4) has assets not used directly in carrying out the exempt purpose(s) of the organization that have an aggregate fair market value of at least \$500,000 per student.

Section 4968(d)(1) states that the assets and net investment income of a related organization of the educational institution will be treated as assets and net investment income of the educational institution. Section 4968(d)(2) defines a related organization as any organization that controls or is controlled by the educational institution, is controlled by one or more persons that also control the educational institution, is a supported organization as defined in Section 509(f)(3) with respect to the educational institution, or is described in Section 509(a)(3) with respect to the educational institution.

Section 4968(d)(1) provides two limits on when the assets of a related organization are treated as assets of the educational institution. The first limit is that no assets can be taken into account for more than one educational institution. The second limit is that

¹ All section references are to the Internal Revenue Code of 1986, as amended.



assets and net investment income that are not intended for or available for the use or benefit of the educational institution are not treated as assets of the educational institution unless the related organization is controlled by the educational institution or the related organization is described in Section 509(a)(3) with respect to the educational institution.

The application of the statute could be broader than the stated intent unless guidance clarifies the circumstances in which the assets of a non-educational institution are subject to the tax. The purpose of this letter is to inform the Internal Revenue Service (“IRS”) and the Department of Treasury (“Treasury”) of questions arising under the statutory text, and possible clarifications that could be made through regulations. Fundamental to each of these examples is the need for clarification that the assets considered in the application of Section 4968 and its excise tax should only be included to the extent that the assets are available to or dedicated to the use/support of the educational institution.

Example 1

Entity A is an organization exempt from federal income taxes under Section 501(a) as an entity described in Section 501(c)(3). Entity A is an educational organization described in section 170(b)(1)(A)(ii) and, therefore, is not a private foundation because it is described in Section 509(a)(1). It is an applicable educational institution as defined in Section 25A.

Entity B is an organization exempt from federal income taxes under Section 501(a) as an entity described in Section 501(c)(3). Entity B is a publicly supported organization under Section 170(b)(1)(A)(vi) and, therefore, is not a private foundation because it is described in section 509(a)(1). Entity B is not controlled by Entity A. Entity B also meets the criteria to be described in Section 509(a)(3) as a supporting organization of Entity A.

Section 4968 defines as a related organization any organization that is described in Section 509(a)(3) with respect to an educational institution. Further, Section 4968 requires that the assets and net investment income of a related organization be treated as assets and net investment income of the educational institution. The limitation that excludes assets that are not intended or available for the use of the educational institution does not apply for organizations that are described in Section 509(a)(3).

In the example above, Entity A could be required to include all of Entity B’s assets and net investment income in its calculations, regardless of whether the assets or net investment income are intended for or available for use by Entity A. This conclusion could be the same if Entity B were a publicly supported organization under Section 509(a)(2) that was also described in Section 509(a)(3).

We ask the IRS and Treasury to consider issuing guidance providing that an organization should be treated as either a Section 509(a)(1) or Section 509(a)(2) organization for purposes of Section 4968 where the organization is described in both Section 509(a)(1) or Section 509(a)(2) and Section 509(a)(3). Thus, the educational

institution would only be required to include assets and net investment income of the related organizations that are held solely for the use of the education institution. This treatment would be in line with the guidance provided in Treasury Regulation 1.509(a)-6 which states: “if an organization is described in section 509(a)(1) and also in another paragraph of section 509(a), it will be treated as described in section 509(a)(1).”

Example 2

Entity C is an organization exempt from federal income taxes under Section 501(a) as an entity described in Section 501(c)(3). Entity C is part of a hospital system composed of dozens of entities. Entity C is a parent organization that supports 35 Section 509(a)(1) and 509(a)(2) entities that are part of the hospital system. Of its 35 supported organizations, 25 are hospitals as defined under Section 170(b)(1)(A)(iii), five entities are nursing schools that are educational institutions as defined in Section 25A (the “schools”), and five are publicly supported organizations under Section 509(a)(2). Entity C reported more than \$250 million of investment assets and more than \$30 million of investment income on its Form 990.

Entity C is a supporting organization described in Section 509(a)(3) with respect to the schools, among other organizations, and therefore could potentially be considered a related organization within the meaning of Section 4968(d)(2). If Entity C is a related organization for purposes of section 4968, the investment income and assets of Entity C would be included when computing the tax the schools owe under Section 4968, with the limitation that the investment income and assets should not be taken into account for more than one of the schools.

The \$30 million of Entity C investment income would be fully subject to tax at 1.4 percent resulting in a yearly tax liability of \$420,000. The majority of the tax under Section 4968 would be payable on investment income that is not now nor likely ever will be used in support of the schools. If you were to assume that support is provided equally to each of Entity C’s supported organizations, only 14.3 percent, or roughly \$4.3 million, of the total investment income would be used in support of the schools. If all of the investment income were used to support charity care for patients in need, then it would be entirely inconsistent with the statute and its underlying policy to tax the investment income as the income would not be the investment income of a private college or university.

The Senate amendment to The Act introduced the inclusion of related organization investment income and assets when determining the assets and investment income of the educational institution. The statutory language says that “an organization described in section 509(a)(3) during the taxable year with respect to such institution.” This language appears to refer to an organization that supports an educational institution and only an educational institution, not to a supporting organization that supports multiple organizations only one of which may be an educational institution. The committee report states that “assets of a related organization that are earmarked or restricted for (or fairly attributable to) the educational institution would be treated as assets of the educational institution, whereas assets of a related organization that are held for unrelated purposes

(and are not fairly attributable to the educational institution) would be disregarded.” However, this statement again assumes the assets of the supporting organization are “earmarked,” in other words, specifically designated for the benefit of the educational institution alone. It is reasonable to assume that it was not the intention of Congress to cause investment income and assets held by supporting organizations that support multiple entities including non-educational institutions and that are not designated for specific uses or directed to specific supported organizations to become fully taxable.

We recommend that it be made clear for organizations that support multiple organizations, only some of which are educational institutions subject to the tax under Section 4968, that the investment income and assets should be allocated among all supported organizations in an economically representative way. Further, the investment income and assets should only be included in the calculation to the extent that the educational institution as defined in Section 25A is able to access (directly and unilaterally without action required on the part of any other person) the investment income and assets of the supporting organization. We believe this would result in the most equitable application of Section 4968. Requiring an educational institution to pay excise tax on investment income and assets that neither currently support its operations nor will support its operations in the future is an overly broad application of Section 4968.

The complex nature of hospital systems can produce a variety of support relationships that evolve over time. We recommend that the IRS and Treasury acknowledge that organizations not listed as supported organizations on a supporting organization’s Schedule A should not be required to consider the investment income or assets of an organization which may have been considered to stand in a supporting organization relationship in the past.

Example 3

Entity D is an organization exempt from federal income taxes under Section 501(a) as an entity described in Section 501(c)(3). Entity D is a hospital described in Section 170(b)(1)(A)(iii) and, therefore, is not a private foundation as it is described in section 509(a)(1). Entity D operates a hospital facility. Embedded within the hospital facility is a nursing school which is an educational institution as defined in Section 25A. The hospital facility and the nursing school are both part of a single nonprofit organization. Roughly 80 percent of Entity D’s income is related to the operation of the hospital facility; 15 percent of the income is related to the operation of the nursing school, and the remaining 5 percent is investment income.

The first question in this example is whether Entity D is an applicable educational institution. Even though Entity D operates a nursing school (an applicable educational institution as defined in Section 25A) as one of its activities, that nursing school is not a separate legal entity and, therefore, not a taxpayer by itself. The primary exempt purpose of the entity D is being a hospital. Entity D is classified as a hospital under section 170(b)(1)(A)(iii), not as an educational institution under section 170(b)(1)(A)(ii). Section 4968 imposes tax on an “applicable educational institution,” and since liability

must attach to a taxpayer, the language should mean that the tax applies only to a taxpayer, whose primary exempt purpose is as an educational institution. We recommend that it be made clear for organizations that conduct multiple functions, only one of which is an educational institution as defined in Section 25A, that the organization not be classified as an applicable educational institution unless its primary exempt purpose is to operate an educational institution.

We believe the suggestions above would apply the language of Section 4968 appropriately and in keeping with the underlying policy. Treating a hospital as an educational institution would be an unfair reading of the statute, particularly after the controversy over medical resident FICA in which the government consistently took the position in litigation that teaching hospitals were not schools. Requiring an educational institution to pay excise tax on investment income and assets that neither currently support its operations nor will support its operations in the future is an overly broad application of Section 4968.

We appreciate the opportunity to share our concerns and suggestions as you develop guidance related to The Act. We would welcome the opportunity for further communication between our organizations. Please contact me at 202-626-2336 or mhatton@aha.org.

Sincerely,



Melinda Reid Hatton
General Counsel

cc:

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