

September 28, 2020

Final Regulations Released Addressing “Endowment Tax” on Net Investment Income of Private Colleges and Universities

On September 18, 2020, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “IRS”) released final regulations ([TD 9917](#), the “Final Regulations”) providing guidance on the excise tax imposed on the net investment income (“NII”) of certain private colleges and universities under section 4968 of the Internal Revenue Code.

Added to the Internal Revenue Code as part of the Tax Cuts and Jobs Act in 2017, section 4968 imposes a 1.4% excise tax on the NII of “applicable educational institutions,” which are generally private colleges and universities that have more than 500 tuition-paying students, more than 50% of whom are located in the United States, and that hold assets (other than assets used directly in carrying out the institution’s exempt purpose) of at least \$500,000 per student.

Treasury and the IRS previously issued proposed regulations under section 4968 in July 2019 (the “Proposed Regulations”). The Proposed Regulations were criticized by many colleges and universities. Comments prepared by Ropes & Gray LLP, among others, were effective in convincing Treasury and the IRS to make numerous helpful modifications to the Proposed Regulations. The most significant of these changes are highlighted below.

Calculation of NII

Section 4968 generally requires that NII be determined under rules similar to those under section 4940(c), which imposes an excise tax on the NII of private foundations. Recognizing that there are important differences between educational institutions and private foundations, the Final Regulations do not simply import all the rules of section 4940(c) into section 4968, which would have resulted in many types of income typically earned by colleges and universities being included in NII. Instead, the Final Regulations set forth specific rules for calculating NII, including:

- **Pre-donation appreciation in donated property:** The Final Regulations exclude from NII any appreciation in the value of donated property that occurred prior to the date of its donation to the applicable educational institution, such that a college or university subject to the excise tax will not pay the NII tax on appreciation in the donated property that occurred prior to the donation. This exclusion is a significant departure from the rules applicable to private foundations under section 4940, which generally tax appreciation whether arising prior to or after the contribution of such property to a private foundation.
- **Capital gain net income on sale of exempt-use property:** The Final Regulations exclude from NII any gain from property used for the educational institution’s exempt purposes. If property is used for both exempt and non-exempt purposes, gain from the exempt-use portion is excluded.
- **Student loan interest:** Interest from student loans is not included in NII.
- **Rental income from student, faculty and staff housing:** Rental income from student, faculty and staff housing is generally not included in NII.
 - **Practical note:** The Final Regulations provide that this exclusion applies to rental income from faculty and staff housing only “if the housing is provided contingent on [the tenants’] roles as faculty or staff of the applicable educational institution,” such as if the rental agreement requires that the tenant be currently employed as faculty or staff. This requirement could limit the availability of the exclusion for colleges and universities that do not make faculty and staff housing explicitly contingent on continued employment.

- **Royalty income from exempt functions:** Royalty income derived from patents, copyrights and other intellectual and intangible property is not included in NII “to the extent those assets resulted from the work of student(s) or faculty member(s) in their capacities as such with the applicable educational institution.” This exclusion does not apply to royalty income from trademarks on the institution’s logo or name or royalty income from intellectual property donated or sold to the institution, and such income is included in NII.
- **Capital loss carryovers:** The Final Regulations permit an applicable educational institution with net capital losses in one year to carry such losses forward to reduce capital gains in future years for purposes of calculating NII. This represents a significant departure from the rules applicable to private foundations.
- **Step-up for partnership assets/partnership interests:** The Proposed Regulations allowed applicable educational institutions to step up their basis in assets held as of December 31, 2017 and at all times thereafter (including through partnerships) to their fair market value as of December 31, 2017, with the effect that appreciation in such assets accruing prior to enactment of section 4968 would not be subject to the excise tax. The Final Regulations retain this general rule for all assets, but adopt a special rule for assets held through partnerships. In response to concerns that determining the basis of each asset held through a partnership would be burdensome, and at times near impossible, the Final Regulations provide that the step-up for assets held through a partnership is determined by reference to an institution’s adjusted basis in the partnership interest itself – i.e., the institution’s “outside basis.” This rule effectively uses the fair market value of the partners’ interests in a partnership as a proxy for the fair market value of the partnership’s assets as of December 31, 2017. Under this rule, an educational institution receives, with respect to each partnership interest, an “unadjusted step-up amount” equal to the amount by which the fair market value of the institution’s partnership interest exceeds the institution’s adjusted basis in such partnership interest as of December 31, 2017. The institution can then use up to one-third of the unadjusted step-up amount in a given year to reduce its capital gain net income from the relevant partnership. A similar rule applies to sales of partnership interests.
 - Practical note: During the institution’s first taxable year beginning after December 31, 2017, the reduction in capital gain net income taken into account in NII is applied to both long-term and short-term capital gain derived from a partnership. Thereafter, it is applied only to long-term capital gain, as assets held as of December 31, 2017 would only give rise to long-term capital gain after the initial year.

Related Organizations

Under section 4968, the assets and NII of any “related organization” are included when determining whether an educational institution meets the threshold requirements for application of the excise tax and when calculating the institution’s excise tax liability. The Final Regulations clarify the definitions relevant in determining whether an organization is a “related organization” and provide several exceptions that narrow the scope of entities and assets that need to be considered.

- **Excluded entities:** The Final Regulations exclude certain entities from the definition of “related organizations” altogether, including taxable corporations and certain taxable trusts, partnerships, S corporations and other flow-through entities, charitable remainder trusts, most charitable lead trusts, estates and certain funded benefit plan arrangements.
 - Practical note: Whether benefit plan vehicles constitute “related organizations” generally depends on whether such vehicles are funded, meaning that assets held by such vehicles are no longer available for general use by the institution and cannot be reached by the institution’s creditors.

- **Definition of control:** Section 4968(d)(2) defines a “related organization” as any organization that (1) controls the educational institution; (2) is controlled by the educational institution; (3) is controlled by one or more persons that also control the educational institution; (4) is a supported organization (as defined in section 509(f)(3)) with respect to the educational institution during the taxable year; or (5) is a supporting organization (as described in section 509(a)(3)) with respect to the educational institution during the taxable year. Section 4968 does not define “control” for these purposes. Acknowledging concerns that “control” as defined by the Proposed Regulations would create unintended consequences, such as educational institutions having to take into account assets and NII that they do not control and will never receive, the Final Regulations define control separately for organizations that control an educational institution, that are controlled by an educational institution and that are controlled by one or more persons that also control an educational institution. Separate rules are provided for different types of organizations, such as tax-exempt corporations, nonstock organizations and trusts.
- **Supporting Organizations:** The Final Regulations retain the rule contained in the Proposed Regulations that any related organization that was a Type III supporting organization of the educational institution as of December 31, 2017 is treated in the same manner as an organization not controlled by the educational institution. The educational institution is thus required to take into account such a supporting organization’s assets and income only to the extent they are intended or available for the use or benefit of the educational institution. The Final Regulations do not adopt taxpayer recommendations to expand this special rule to Type III supporting organizations established after December 31, 2017 or to other types of supporting organizations.

Identifying Educational Institutions Subject to the Excise Tax

The Final Regulations further clarify certain other requirements and definitions relevant to identifying which educational institutions are subject to the excise tax.

- **Exempt-use assets:** For purposes of the assets-per-student threshold, the Final Regulations provide guidance on the scope of assets treated as used directly in carrying out an institution’s exempt purpose. This is important because an institution must calculate assets-per-student to determine whether it is subject to the excise tax, and exempt-use assets are excluded from this calculation.
 - **Reasonable cash balance:** Like the Proposed Regulations, the Final Regulations permit an educational institution to treat a portion of its cash balance as exempt-use assets. Whereas the Proposed Regulations included a safe harbor for such reasonable cash balance equal to 1.5% of the fair market value of the non-charitable use assets of the institution, the Final Regulations permit an educational institution to use any reasonable method to determine the reasonable cash balance necessary to cover current operating and administrative expenses and other normal and current disbursements directly connected with the educational institution’s exempt activities.
 - Practical Note: The Final Regulations note that a reasonable method would include calculating an amount equal to three months of operating expenses allocable to program services by dividing annual functional expenses allocable to program services by four.
 - **Assets of Related Organizations:** The Final Regulations clarify that the exclusion for exempt-use assets applies to assets of related organizations that are used directly in carrying out (a) the educational institution’s exempt purpose and (b) in the case of a related 501(c)(3) organization, the related organization’s own exempt purpose (which could differ from that of the educational institution).

- **Intangible assets:** The Final Regulations make clear that intellectual property that produces royalties excluded from NII (i.e., patents, copyrights and other intellectual and intangible property that resulted from the work of student(s) or faculty member(s) in their capacities as such with the applicable educational institution) are treated as exempt-use assets. The Final Regulations provide that trademarks on an institution's logo or name and intellectual property donated or sold to the institution are not exempt-use assets.
- **Definition of “student” and “tuition-paying”:** The Final Regulations broaden the definition of “student” to provide that a student need not be enrolled in a degree program, but rather must be “a person who is enrolled and attending a course for academic credit from the institution and who is being charged tuition at a rate that is commensurate with the tuition rate charged to students enrolled for a degree.” Furthermore, the Final Regulations provide that students who are receiving government grants or grants directly from the educational institution will not be considered tuition-paying as a result of such grants, but those who receive grants from third parties generally will be considered to be tuition-paying.

Effective Date

The Final Regulations apply to taxable years of educational institutions beginning after the date of publication in the Federal Register, which is expected to take place within the next several weeks.

For more information, please contact a member of the [Tax-Exempt Organizations](#) practice.