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# IRS Issues Guidance on “Endowment Tax” for Colleges and Universities

On July 3, 2019, Treasury and the IRS published [proposed regulations](#) on the new excise tax on the net investment income of certain private colleges and universities under section 4968 of the Internal Revenue Code.<sup>1</sup> The tax was enacted as part of the Tax Cuts and Jobs Act at the end of 2017.

Section 4968 imposes a tax equal to 1.4% of the “net investment income” of an “applicable educational institution” for taxable years beginning after December 31, 2017. The proposed regulations define many of the terms used to determine whether an institution is subject to the tax, details the calculation of net investment income for purposes of the tax, and defines “related organizations” for purposes of section 4968, a term important to both determining the calculation of the tax and whether an institution is subject to the tax. Taxpayers may rely on the proposed regulations for taxable years beginning before publication of final regulations. The proposed regulations request comments on many interpretive questions, with comments due by October 1, 2019.

## Definition of “Applicable Educational Institution”

To be subject to the tax as an applicable educational institution, the institution must be an “eligible educational institution” as defined in section 25A(f)(2), (A) that had at least 500 tuition-paying students attending the institution during the preceding taxable year, (B) more than 50% of whom are located in the United States, (C) that is not a state college or university, and (D) with assets (other than assets which are used directly in carrying out the institution’s exempt purpose) that have an aggregate fair market value that is at least \$500,000 per student. The proposed regulations provide definitions for the terms “student,” “tuition-paying,” and “located in the United States,” and the phrase “assets which are used directly in carrying out the institution’s exempt purpose,” all of which are critical to determining whether an institution is subject to the tax.

- ***Student:*** The proposed regulations define “student” as “a person enrolled in a degree, certification, or other program . . . leading to a recognized educational credential at an institution, and who is not enrolled in an elementary or secondary school.” Therefore, it is not sufficient that an individual simply attend an institution to be considered a student for section 4968 purposes; the individual must also be enrolled in a program.
  - For purposes of section 4968, part-time students are “taken into account on a full-time student equivalent basis.” The proposed regulations provide that an institution may make its own determination of standards for determining part-time students, full-time students, full-time equivalents, and daily average number of full-time students attending the institution, although the institution may not use standards lower than those established by the Department of Education under the Higher Education Act.
- ***Tuition-Paying:*** The proposed regulations define “tuition-paying” as “the payment of any tuition or fees required for the enrollment or attendance of a student for a course of instruction at an educational institution.”
  - This does not include payments for supplies or equipment or payments of living expenses such as room and board.
  - The determination of whether a student is “tuition-paying” is made after taking into account any scholarships or work-study programs provided directly by the institution (i.e., scholarship payments by third parties are

<sup>1</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

considered tuition payments on behalf of the student, but scholarship support provided directly by the institution is not).

- *Located in the United States*: The proposed regulations provide that a student is considered to have been located in the United States if the student resided in the United States for at least a portion of the time that the student attended the educational institution during the institution's preceding taxable year.
- *Assets Used Directly in Carrying out the Institution's Exempt Purpose*: The proposed regulations generally follow the regulations under section 4942 (related to the private foundation minimum distribution requirement) to determine whether an institution's assets are used directly in carrying out its exempt purpose (an "exempt use asset"). The determination of exempt use assets is important because these assets are excluded in determining whether the \$500,000 per student asset threshold has been exceeded.
  - The proposed regulations indicate that an asset is an exempt use asset "only if the asset is actually used by the institution in carrying out its exempt purpose" based on all the facts and circumstances.
  - The proposed regulations provide several examples of exempt use assets and note that the list is not intended to be exclusive:
    - Administrative assets, such as office equipment and supplies used by the institution directly in the administration of its exempt activities;
    - Real estate or the portion of any building used by the institution directly in its exempt activities;
    - Physical property such as paintings or other works of art owned by the institution that are on public display, fixtures and equipment in classrooms, research facilities and related equipment that under the facts and circumstances serve a useful purpose in the conduct of the institution's exempt activities;
    - The reasonable cash balances necessary to cover current administrative expenses and other normal and current disbursements directly connected with the institution's exempt activities. A cash balance of 1.5% of the fair market value of the institution's non-charitable-use assets, determined without regard to any reduction for reasonable cash balances, will be deemed a reasonable cash balance; and
    - Any property the educational institution leases to other persons at no cost (or at a nominal rent) to the lessee in furtherance of the institution's exempt purpose.
  - The proposed regulations also provide two examples of assets that are not exempt use assets:
    - Assets that are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or leased real estate), even if the income from such assets is used to carry out such exempt purpose; and
    - Property (such as offices) used for the purpose of managing the institution's endowment funds.

### Calculation of Net Investment Income

Section 4968 imposes a tax on applicable educational institutions equivalent to 1.4% of the institution's net investment income for the taxable year, and provides that net investment income is "determined under rules similar to the rules of section 4940(c)." Section 4940(c) relates to the calculation of the excise tax imposed on a private foundation's net investment income. The proposed regulations adopt the rules provided in section 4940(c) and the associated regulations,

with little attention to the differences between private foundations and educational institutions. Accordingly, the definition includes gross amounts of income received from all sources, except to the extent included in computing the tax on unrelated business taxable income. Most notably, the definition clearly includes income derived from assets that are devoted to charitable and educational activities.

In particular, the proposed regulations treat interest income derived from student loans and educational housing (such as student dormitory rentals) as included in the definition of net investment income and therefore subject to the excise tax, although Treasury and the IRS acknowledge that both activities can be seen as helping an institution fulfill its mission of educating its students and therefore request comments on how carving those categories of income out from the definition of net investment income would be consistent with section 4968.

The proposed regulations provide an important transition rule for assets held before section 4968 was enacted:

- Consistent with IRS Notice 2018-55 (released June 8, 2018), for property held by an applicable educational institution on December 31, 2017 and continuously thereafter to the date of its disposition, the basis of such property for determining gain is deemed to be not less than the fair market value of such property on December 31, 2017, plus or minus all adjustments after December 31, 2017 and before the date of its disposition. This is effectively an initial basis step-up in assets for purposes of the first year of calculating the excise tax.
- The proposed regulations clarify that the initial basis step-up applies to assets held directly as well as assets held through one or more tiers of partnerships. However, to take advantage of this “special partnership basis rule,” the institution must obtain documentation from the partnership to substantiate the partnership’s basis in the assets.

The proposed regulations, however, do not include a similar basis step-up rule with respect to charitable contributions of appreciated property contributed after December 31, 2017. Accordingly and as explained in the preamble to the proposed regulations, an institution takes a carryover basis in appreciated property contributed by a donor for purposes of calculating its net investment income upon a subsequent sale of such property.

Finally, educational institutions are permitted to use overall net losses from sales or other dispositions of property by the institution or related organizations to reduce overall net gains from such sales or other dispositions by the institution or related organizations (but not below zero).

### Related Organizations

Under section 4968, the assets and net investment income of related organizations are treated as assets and net investment income of the applicable educational institution. This means assets of related organizations are included to determine whether an institution is subject to the excise tax, and if the excise tax applies, the net investment income of all of the institution’s related organizations (not just the net investment income of the institution itself) is subject to the tax. A “related organization” is defined to generally mean an organization that (A) controls, or is controlled by, the applicable educational institution; (B) is controlled by one or more persons that also control the applicable educational institution; or (C) is a “supported organization” or a section 509(a)(3) “supporting organization” of the applicable educational institution.

- Control: The proposed regulations define “control” as follows:
  - In the case of a corporation, ownership by vote or value of more than 50% of the corporation’s stock;
  - In the case of a partnership, ownership of more than 50% of the profits interests or capital interests;
  - In the case of a trust with beneficial interests, ownership of more than 50% of the beneficial interests; or

- In the case of a nonprofit organization or other organization without owners or persons having beneficial interests, including a government entity, more than 50% of the directors or trustees of the applicable educational institution or nonstock organization are either representatives of, or are directly or indirectly controlled by, the other entity, or more than 50% of the directors or trustees are either representatives of, or are directly or indirectly controlled by, one or more persons that control the applicable educational institution.

Section 318, which contains rules for determining constructive ownership of stock, applies for purposes of determining ownership of stock in a corporation, and similar principles apply for purposes of determining ownership of an interest in any other entity.

This definition is consistent with the definition of “control” adopted in IRS Notice 2019-09 (released December 31, 2018) for purposes of section 4960 (the excise tax on certain executive compensation arrangements of tax-exempt organizations) and the definition of “related organization” on the IRS Form 990 annual information return.

To determine the aggregate fair market value of the assets and net investment income of an educational institution, the assets and net investment income of any related organization are generally treated as the assets and net investment income of the institution, unless one of the following exceptions applies:

- No amount may be taken into account with respect to more than one educational institution.
  - When an organization is related to more than one educational institution (e.g., a supporting organization that supports multiple colleges), its assets and net investment income must be allocated among the educational institutions it supports.
- In general, the assets and net investment income of a related organization are not taken into account by the institution if they are not intended or available for the use and benefit of the institution.
  - Assets or net investment income specifically earmarked or restricted for another entity or for unrelated purposes are not generally considered intended or available for the use and benefit of the educational institution.
  - The assets and net investment income of a related organization must be allocated between those that are intended or available for the use and benefit of an educational institution and those that are not.
  - There is an exception to the general rule above for a related organization controlled by an educational institution, or a related organization that is a section 509(a)(3) supporting organization with respect to that institution. Under those circumstances the assets and net investment income of the related organization are taken into account by the educational institution, even if they are specifically earmarked or restricted for another entity or for unrelated purposes.
- Under the proposed regulations, an institution with a related organization that was a Type III supporting organization with respect to the institution on December 31, 2017 takes into account only the assets and net investment income of that organization that are intended or available for the use and benefit of, “or otherwise fairly attributable to,” the institution. The institution can determine whether assets and net investment income are intended or available for its use and benefit using any reasonable method. The following methods are deemed to be reasonable:
  - A method that treats all the distributions received from such Type III supporting organization as net investment income of the institution each year; and

- A method that uses the distributions received from the Type III supporting organization to calculate the percentage of the Type III supporting organization's total net income that was distributed to the educational institution, and then uses the same percentage to calculate the value of the underlying assets of the Type III supporting organization that are intended or available for the use and benefit of the educational institution each year.

If you have any questions about the proposed regulations, please contact a member of the [tax-exempt organizations](#) practice.