



TaxNewsFlash

Exempt Organizations

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KPMG report: Initial impressions of final regulations, excise tax on college net investment income

The IRS on September 18, 2020, posted on its website final regulations (T.D. 9917) under section 4968, which imposes an excise tax of 1.4% on the net investment income of certain private colleges and universities with at least 500 tuition-paying students and endowments valued at \$500,000 or more per student (“applicable educational institutions” or “AEIs”).

Read the [final regulations](#) [PDF 551 KB] (156 pages) as released by the IRS.

Background

Section 4968 was added by the 2017 tax law (Pub. L. No. 115-97), the law that is often referred to as the “Tax Cuts and Jobs Act,” and proposed regulations implementing section 4968 were published on July 3, 2019.

In defining “net investment income” for purposes of section 4968, the proposed regulations did little more than cross-reference the rules governing a similar excise tax applicable to private foundations, and were criticized for failing to take into account the significant differences between the operations of a college or university and a typical private foundation. The proposed regulations also relied heavily on the rules applicable to private foundations to define which of the institution’s assets would be considered “used directly in carrying out the institution’s exempt purpose” (that is, “exempt-use” assets) that can be excluded in calculating whether the \$500,000-per-student threshold has been crossed.

Final regulations

The final regulations under section 4968 respond to the criticisms of the proposed regulations, by making numerous changes to the proposed regulations that are favorable for AEIs, and better take into account the differences between these educational institutions and private foundations.

Certain key provisions of the final regulations include the following measures.

- When determining whether an educational institution crosses the 500-student or \$500,000-per-student asset thresholds, the final regulations:
 - Broaden the definition of “student” to include any person who is enrolled and attending a course for academic credit from the institution and is charged tuition at a rate commensurate with the rate charged to students enrolled for a degree.
 - In determining whether a student is “tuition-paying,” provide that grants from the federal government or any state or local government (and from the institution) are disregarded, although scholarships and grants from private parties are still considered payments of tuition on behalf of the student.
- - Provide new safe harbors that permit an institution to exclude from its assets the value of certain intellectual and intangible property and an operating reserve amount equal to three months of operating expenses incurred in conducting the institution’s exempt activities (greater amounts may be excluded if justified under the facts and circumstances of the institution).
- For purposes of defining “related organizations,” whose assets and net investment income must be taken into account by an AEI when computing both the per-student asset threshold and its net investment income, the final regulations provide:
 - Several types of entities are categorically excluded including: (1) taxable corporations; (2) charitable remainder trusts, (3) partnerships, S corporations, and other pass-through entities; (4) estates; (5) grantor charitable lead trusts; (6) trusts or similar funding vehicles of an employee benefit plan or arrangement (though not of an unfunded employee benefit plan, such as a 457(b) or 457(f) plan); and (7) many taxable trusts, including non-grantor charitable lead trusts, unless the trust meets certain specified definitions of control.
 - New and separate definitions of “control” for organizations that control an AEI, that are controlled by an AEI, and that are controlled by one or more persons that also control an AEI.
- When calculating an AEI’s net investment income, the final regulations, like the proposed regulations, generally look to the rules under section 4940 which imposes an excise tax on the net investment income of private foundations. However, unlike the proposed regulations, the final regulations:
 - Exclude interest income from student loans made to an AEI’s students and rental income from housing provided to an AEI’s students, faculty, and staff
 - Exclude royalty income from patents, copyrights, and other intellectual property resulting from the work of an AEI’s students or faculty—but not royalty income from trademarks on the institution’s logo or name or from intellectual property donated or sold to the AEI
 - Disregard gain from the sale or exchange of exempt-use assets
 - Allow capital loss carryovers to offset capital gains in future years
 - Exclude capital gain attributable to appreciation of donated property that occurred prior to the donation

- In addition, in order to take into account appreciation inside a partnership prior to the effective date of the law, the final regulations provide that an AEI may reduce its distributive share of long-term capital gain from a partnership interest that was held by the AEI on December 31, 2017, by the difference between the partnership interest's fair market value on December 31, 2017, and its adjusted basis on December 31, 2017 (capped at one-third of this difference per year).

Effective date

The final regulations are effective the first tax year beginning after the date of publication in the Federal Register (anticipated to occur within the next few weeks). Therefore, for institutions with a June 30 year-end, the new regulations will be effective for tax years beginning July 1, 2021.

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