



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 53

[REG-106877-18]

RIN 1545-BO75

Guidance on the Determination of the Section 4968 Excise Tax Applicable to Certain Private Colleges and Universities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations for determining the excise tax applicable to the net investment income of certain private colleges and universities, as provided by the Tax Cuts and Jobs Act. These regulations affect applicable educational institutions and their related organizations.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at <http://www.regulations.gov> (indicate IRS and REG-106877-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-106877-18), Room 5203, Internal

Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-106877-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Melinda Williams at (202) 317-6172 or Amber L. MacKenzie at (202) 317-4086; concerning submission of comments and request for hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations under section 4968 of the Internal Revenue Code (Code) to amend part 53 of the Excise Tax Regulations (26 CFR part 53). Section 4968 of the Code, added by section 13701 of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2167-68, (2017) (TCJA), imposes on each applicable educational institution, as defined in section 4968(b)(1), an excise tax equal to 1.4 percent of the institution's net investment income, and, as described in section 4968(d), a portion of certain net investment income of certain related organizations, for the taxable year.

Section 4968(b)(1) defines the term "applicable educational institution" as an eligible educational institution (as defined in section 25A(f)(2)) which during the preceding taxable year had at least 500 tuition-paying students, more than 50 percent of whom were located in the United States, is not a state college or university as described in the first sentence of section 511(a)(2)(B), and had assets (other than those assets

used directly in carrying out the institution's exempt purpose) the aggregate fair market value of which was at least \$500,000 per student of the institution.

Section 4968(b)(2) provides that, for purposes of section 4968(b)(1), the number of students of an institution (including for purposes of determining the number of students at a particular location) shall be based on the daily average number of full-time students attending such institution (with part-time students taken into account on a full-time student equivalent basis).

Section 4968(c) provides that, for purposes of section 4968, "net investment income" shall be determined under rules similar to the rules of section 4940(c).

Section 4968(d)(1) provides that, for purposes of determining aggregate fair market value of an educational institution's assets not used directly in carrying out its exempt purpose¹ and for purposes of determining an institution's net investment income, the assets and net investment income of any related organization with respect to the institution shall be treated as assets and net investment income, respectively, of the educational institution, with two exceptions. First, no such amount shall be taken into account with respect to more than one educational institution. Second, unless such organization is controlled by such institution or is described in section 509(a)(3) (relating to supporting organizations) with respect to such institution for the taxable year, assets and net investment income which are not intended or available for the use or benefit of the educational institution shall not be taken into account.

¹ Section 4968(d)(1) erroneously cross references section 4968(b)(1)(C). The correct cross reference should be to section 4968(b)(1)(D). See Joint Committee on Taxation, "General Explanation of Public Law No. 115-97" (JCS-1-18), December 2018, at 290, n. 1357.

Section 4968(d)(2) provides that the term “related organization,” with respect to an educational institution, means (1) any organization which controls, or is controlled by, such institution; (2) is controlled by one or more persons that also control such institution; or (3) is a supported organization (as defined in section 509(f)(3)), or a supporting organization (as described in section 509(a)(3)), during the taxable year with respect to the educational institution.

The Conference Report for the TCJA, H. Rept. 115-466, 115th Cong., 1st sess., December 15, 2017 (Conference Report), at 555, states that Congress intended that the Secretary of the Treasury promulgate regulations to carry out the intent of section 4968, including regulations that describe: (1) Assets that are used directly in carrying out an educational institution’s exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of an educational institution.

In June 2018, the Treasury Department and the IRS issued Notice 2018-55 (2018-26 I.R.B. 773) (Notice) to provide interim guidance on certain issues related to the application of the tax imposed by section 4968. Specifically, Notice 2018-55 states that, in the case of property held on December 31, 2017, and continuously thereafter to the date of its disposition, the Treasury Department and the IRS intend to propose regulations stating that basis for purposes of determining gain (but not loss) shall be 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 disposition consistent with the regulations under section 4940(c). The Notice provides that, if the disposition of an asset would result in a capital loss, basis rules that are

consistent with the regulations under section 4940(c) will apply. Accordingly, if the value of the asset declines after December 31, 2017, the taxpayer will recognize no gain; however, the taxpayer will recognize a loss only if the proceeds from the sale of the asset are less than the basis of the property as calculated without the special rule in the Notice to increase the basis to fair market value on December 31, 2017. The Notice additionally states that the Treasury Department and the IRS expect the proposed regulations to provide that losses from sales or other dispositions of property generally shall be allowed only to the extent of gains, with no capital loss carryovers or carrybacks, and that losses from sales or other dispositions of property by related organizations will be allowed to offset overall net gains from other related organizations or the applicable educational institution. The Notice provides that applicable educational institutions may rely on the Notice before the issuance of the proposed regulations. Finally, the Notice requests comments on any of the issues addressed in the Notice and on any additional guidance that is needed and whether, and what type of, transitional relief may be necessary.

The Treasury Department and the IRS received two comments in response to Notice 2018-55, which were considered in drafting these proposed regulations. The comments are available at <http://www.regulations.gov> or upon request.

Explanation of Provisions

1. Institutions Subject to the Tax

Section 4968(a) imposes a 1.4 percent excise tax on the net investment income of each applicable educational institution. Section 4968(b) provides that an applicable educational institution is an “eligible educational institution” (as defined in section

25A(f)(2)) if: (i) it had at least 500 tuition-paying students during the preceding taxable year; (ii) more than 50 percent of its tuition-paying students are located in the United States; (iii) it is not a state college or university as described in the first sentence of section 511(a)(2)(B); and (iv) the aggregate fair market value of its assets (other than those assets used directly in carrying out the institution's exempt purpose) was at least \$500,000 per student of the institution at the end of the preceding taxable year. Section 53.4968-1(a) of these proposed regulations sets forth definitions to determine whether an entity is an applicable educational institution that is subject to the tax.

Although, pursuant to section 4968(a), the tax on net investment income for each taxable year is based on the net investment income of an applicable educational institution for such taxable year, for purposes of determining whether an institution is an “applicable educational institution” subject to the tax, section 4968(b) provides that the number of an institution’s tuition-paying students and the aggregate fair market value of the institution’s assets (and the assets of any related organization) are based on the preceding taxable year’s number and value.

A. Eligible Educational Institution Defined in Section 25A(f)(2)

Section 4968(b)(1) defines “applicable educational institution,” in part, as an eligible educational institution defined in section 25A(f)(2). In accordance with section 4968(b), the proposed regulations provide that an applicable educational institution must be described in section 25A(f)(2) and the regulations thereunder. Section 25A(f)(2) provides that, for purposes of the allowance of American Opportunity and Lifetime Learning credits, the term “eligible educational institution” means an institution (1) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C.

1088) (HEA), as in effect on the enactment of section 25A (1997), and (2) which is eligible to participate in a program under title IV of the HEA (relating to the United States federal student financial aid programs). The Treasury Department and the IRS anticipate that colleges and universities already know whether they are described in section 25A, but request comments on whether further guidance is needed for purposes of applying section 4968.

B. Student

i. In General

Section 4968(b)(1) defines “applicable educational institution,” in part, by reference to the number of its students and the amount of its assets per student. Section 4968 does not define the term “student.” However, section 4968(b)(2) does provide that the number of students of an institution shall be based on the daily average number of full-time students attending an institution, with part-time students taken into account on a full-time student equivalent basis. As described in part 1(A) of this Explanation of Provisions section, the definition of the term “applicable educational institution” in section 4968(b), which references students in some of its definitional criteria, relies on the definition of “eligible educational institution” as defined in section 25A(f)(2).

For purposes of section 25A, the term “eligible student” is defined in section 25A(b)(3) to mean a student who (1) meets the requirements of section 484(a)(1) of the HEA (20 U.S.C. 1091(a)(1)), and (2) is carrying at least half the normal full-time work load for the course of study the student is pursuing. Section 484(a)(1) of the HEA (20 U.S.C. 1091(a)(1)) provides that, in order to receive any grant, loan, or work assistance

under the general provisions relating to student assistance programs under the HEA, a student must be enrolled or accepted for enrollment in a degree, certification, or other program (including a program of study abroad approved for credit by the eligible institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education that is an eligible institution in accordance with the provisions of section 1094 of title 20 of the U.S. Code, except as provided in section 1091(b)(3) and (4) of the HEA,² and not enrolled in an elementary or secondary school.

The Treasury Department and the IRS consider the definition of eligible student under section 25A to be an appropriate basis for the definition of student for purposes of section 4968; however, the requirement found in section 25A(b)(3)(B) that a student must carry at least half the normal full-time work load for the course of study the student is pursuing is not relevant for purposes of section 4968. Section 4968(b)(2) does not contain a requirement that a student must carry at least half the normal full-time work load to be considered a student for purposes of the asset measurement requirement; instead, it states that part-time students are taken into account on a full-time student equivalent basis.

Furthermore, section 4968(b)(2) contains a requirement that the number of students of an institution be based on the daily average number of students attending

² Subsections (b)(3) and (4) of 20 U.S.C. 1091 provide exceptions to section 484(a)(1) of the HEA that allows students to be eligible for certain grant programs even if the student does not qualify under section 484(a)(1). Under the exceptions, the student must be carrying at least one-half the normal full-time work load for the course of study that the student is pursuing, as determined by an eligible institution, and be enrolled in a course of study necessary for enrollment in a program leading to a degree, certificate, professional credential or certification from a State that is required for employment as a teacher in an elementary or secondary school in that State.

the institution. Therefore, the Treasury Department and the IRS do not view the portion of the rule found in Section 484(a)(1) of the HEA that is incorporated into the definition of “student” in section 25A(b)(3)(B) and includes an individual merely “accepted for enrollment” as appropriate to the application of section 4968 since such an individual may not yet be attending the institution.

Accordingly, the proposed regulations generally follow the standard in section 484(a)(1) of the HEA referenced by section 25A(b)(3)(A) to provide that the term “student” for section 4968 purposes means a person enrolled in a degree, certification, or other program (including a program of study abroad approved for credit by the eligible institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution, and not enrolled in an elementary or secondary school. See proposed §53.4968-1(a)(3)(i). However, the proposed definition of student does not include individuals merely accepted for enrollment, nor does it contain a requirement that the student have at least half the normal full-time work load. Furthermore, the time limitations in section 25A(b)(2) (such as that the American Opportunity Tax Credit is allowed only for 4 taxable years) are not part of the definition of “eligible student” and thus are not incorporated into the definition of student for section 4968 purposes.

Putting together the section 4968(b)(2) requirement that a student be “attending” an institution and the proposed definition that a student is an individual enrolled in a degree, certification, or other program leading to a recognized educational credential at an eligible educational institution, in applying the requirements under section 4968(b)(1), the proposed regulations require that a student be both enrolled at and

attending the institution. The Treasury Department and the IRS request comments on whether further guidance is needed on the definitions of “student,” “enrolled,” or “attending.”

Consistent with section 4968(b)(1)(D), the proposed regulations provide that an educational institution determines the fair market value of assets per student based upon the total number of all students, as defined in proposed §53.4968-1(a)(3)(i), attending an eligible educational institution, not just the number of tuition-paying students.

ii. Tuition-paying

Section 4968(b)(1) defines “applicable educational institution,” in part, with respect to how many tuition-paying students attend the institution. Specifically, under section 4968(b)(1)(A) an institution must have had at least 500 tuition-paying students during the preceding taxable year, and under 4968(b)(1)(B), more than 50 percent of its tuition-paying students must have been located in the United States. Section 4968 does not define the term “tuition-paying.”

As described in part 1(A) of this Explanation of Provisions section, section 25A provides certain education credits relating to qualified tuition and related expenses paid by certain eligible students. Section 25A(f)(1) and §1.25A-2(d) provide, in relevant part, that the term “qualified tuition and related expenses” means tuition and fees required for the enrollment or attendance at an eligible educational institution for courses of instruction at such institution. Such term does not include expenses with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual’s degree program.

The Treasury Department and the IRS propose to base the definition of “tuition-paying” for purposes of section 4968 on the definition of qualified tuition and related expenses that is provided in section 25A(f)(1) and the regulations thereunder, without regard to section 25A(f)(1)(D). Thus, the proposed regulations provide that tuition-paying means the payment of tuition and fees required for the enrollment or attendance of a student for courses of instruction at an eligible educational institution but does not include any separate payment for supplies or equipment required during a specific course once a student is enrolled in and attending the course (for example, art supplies). Tuition-paying also does not include payment of room and board or other personal living expenses, and if a student is required to pay a fee (such as a comprehensive fee or a bundled fee) to an eligible educational institution that combines charges for tuition with charges for personal expenses such as room and board, then the student is a tuition-paying student. The Treasury Department and the IRS note that, notwithstanding the reference to “enrollment” for purposes of identifying tuition and fees, the tuition-paying student must also be attending the educational institution for purposes of determining if there are at least 500 tuition-paying students.

For purposes of section 4968, the proposed regulations also provide that whether a student is “tuition-paying” is determined after taking into account any scholarships provided directly by the educational institution and any work study programs operated directly by the educational institution. However, scholarship payments provided by third parties, even if administered by the institution, are considered payments of tuition on behalf of the student. Accordingly, a student will be considered a tuition-paying student for purposes of section 4968 if payment of any tuition or a fee is required for the

enrollment or attendance of the student for courses of instruction after the application of any scholarships offered directly by the institution or work study program operated directly by the institution.

iii. Located in the United States

Section 4968(b)(1)(B) provides, in part, that at least 50 percent of an applicable educational institution's tuition-paying students attending the institution must have been located in the United States. The statute clearly refers to the location of the students, not the location of the educational institution or an instructor. Accordingly, 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 the student attended the educational institution. Like the other requirements of section 4968(b), this measurement is based on the applicable educational institution's preceding taxable year.

For example, a student that attended an educational institution in the preceding taxable year who is citizen of a foreign country is considered to have been a student located in the United States if the student resided in the United States for at least a portion of the time the student attended the educational institution. Furthermore, a student attending the educational institution in the preceding taxable year who was studying abroad in a foreign country is considered to have been a student located in the United States if the student resided in the United States for at least a portion of the time the student attended the educational institution. However, if a student did not reside in the United States for any portion of the time the student attended the education institution during the preceding taxable year, then that student would not be considered

to have been located in the United States for purposes of section 4968(b)(1)(B) (although he or she may still be considered a student for purposes of section 4968(b)(1)(D)). The Treasury Department and the IRS request comments on whether further guidance is needed relating to whether a student is considered to have been located in the United States in a preceding taxable year.

iv. Full-time Students and Part-time Equivalents

Section 4968(b)(2) provides, in part, that the number of students of an applicable educational institution (including for purposes of determining the number of students at a particular location) is based on the daily average number of full-time students attending such institution, with part-time students taken into account on a full-time student equivalent basis. Section 4968 does not define the terms “full-time” and “part-time” for purposes of the full-time equivalent rule in section 4968(b)(2), nor does it provide how to determine a full-time student equivalent or a daily average.

Section 1.25A-3(d)(1)(ii) of the Income Tax Regulations provides for section 25A purposes that the standard for what is half the normal full-time work load is determined by each eligible educational institution; however, the standard for half-time may not be lower than the applicable standard for half-time established by the HEA.

Unlike section 25A, section 4968 does not require that a student be carrying at least half the normal full-time work load for the course of study the student is pursuing in order to be considered a student. However, the Treasury Department and the IRS otherwise view the standard provided in §1.25A-3(d)(1)(ii) as a helpful model in applying the full-time equivalent requirement in section 4968(b)(2) and propose to follow a similar approach.

Accordingly, these proposed regulations provide that, for purposes of section 4968(b)(2), the determinations of full-time students, part-time students, full-time student equivalents, and daily average of students attending the institution are made by each applicable educational institution as long as the determinations are consistent with the institution's practices in determining full-time and part-time status for other purposes. For example, it may be reasonable for an institution to determine that two students, each carrying half a full-time load, are equivalent to one full-time student. However, the standards an institution uses may not be lower than the applicable standards established by the Department of Education under the HEA.

The Treasury Department and the IRS seek comments on whether more specific guidance is required concerning the determination of full-time student, part-time student, full-time equivalent, or daily average number of full-time students attending the institution.

C. Assets Used Directly in Carrying out an Institution's Exempt Purpose

i. In General

To be included within the definition of applicable educational institution under section 4968(b)(1), an institution must have assets (other than those assets which are used directly in carrying out the institution's exempt purpose) the aggregate fair market value of which is at least \$500,000 per student. The phrase "assets which are used directly in carrying out the institution's exempt purpose" is not defined in section 4968, but a similar phrase is used in section 4942.

For purposes of section 4942, a private foundation must determine its minimum investment return as part of its calculation of its distributable amount for any taxable

year. Minimum investment return is defined in section 4942(e) as 5 percent of the excess of the aggregate fair market value of all assets of the foundation “other than those which are used (or held for use) directly in carrying out the foundation’s exempt purpose,” over the acquisition indebtedness with respect to such assets.

Since section 4968 contains a phrase similar to the language used in section 4942 (other than the omission of the parenthetical “or held for use”), the Treasury Department and the IRS propose generally to follow §53.4942(a)-2(c) for purposes of determining whether an educational institution’s assets are used directly in carrying out the institution’s exempt purpose, without regard to provisions relating to private foundation assets “held for use.” The Treasury Department and the IRS seek comments on whether the use of the principles of the section 4942 regulations for this purpose creates any concerns.

Consistent with section 4942, the proposed regulations provide in §53.4968-1(a)(4)(i) that an asset is used directly in carrying out an institution's exempt purpose only if the asset is actually used by the institution in carrying out its exempt purpose. Administrative assets, real estate, and physical property used by the institution directly in its exempt activities are all examples of such exempt purpose assets. In addition, a reasonable cash balance necessary to cover current administrative expenses and other normal and current disbursements directly connected with the educational institution’s exempt activities is considered to be used directly in carrying out the institution's exempt purpose. For section 4942 purposes, a reasonable cash balance is defined as 1.5 percent of the fair market value of the private foundation’s non-charitable use assets (i.e., assets not actually used by an institution in carrying out its exempt purpose),

determined without regard to the reduction for the reasonable cash balance. For consistency with the 4942 rules, the Treasury Department and the IRS propose that a cash balance of 1.5 percent of the fair market value of the educational institution's non-charitable use assets, determined without regard to the deduction for the reasonable cash balance, will be deemed to be a reasonable cash balance for purposes of section 4968. However, the Treasury Department and the IRS note that the 1.5 percent standard in the section 4942 context is an average monthly amount over the entire taxable year and thus has to take into account fluctuations in cash needs. Thus, in light of the differences in the exempt activities of an educational institution and the section 4968 requirement to measure the assets only at the end of the taxable year, the Treasury Department and the IRS request comments on whether another percentage or other measurement should be deemed to be a reasonable cash balance at the end of the taxable year. The Treasury Department and the IRS specifically request comments supporting why any such other amount would be reasonable, and how utilizing a different amount would be administrable.

The proposed regulations do not address whether a functionally-related business would be considered an exempt use asset for the purposes of this test. Although functionally-related businesses are included as an illustration of an exempt use asset in the section 4942 regulations, it is not clear how the concept of a functionally-related business would apply to an educational institution. The Treasury Department and the IRS request comments on whether and how educational institutions use functionally related businesses in conducting their operations and whether functionally-related

businesses should be explicitly included or excluded as examples of exempt use assets in the final regulations.

Whether an asset is used directly by an educational institution to carry out its exempt purpose is determined based on the facts and circumstances. In addition, where property is used both for charitable, educational, or other similar exempt purposes and for other purposes, if the exempt use represents 95 percent or more of the total use, the property is considered to be used exclusively for a charitable, educational, or other similar exempt purpose. If the exempt use represents less than 95 percent of the total use, the institution must make a reasonable allocation between the exempt and nonexempt use.

ii. Exceptions

Similar to the rules under section 4942, the proposed regulations deem certain assets to not be used directly in carrying out an institution's exempt purpose, including assets that are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate), even if the income from such assets is used to carry out the exempt purpose. Similarly, non-exempt use assets include property used for managing endowment funds of the institution.

iii. Valuation of Assets not Used Directly in Carrying out an Institution's Exempt Purpose

For purposes of section 4968(b)(1)(D), the value of an institution's non-exempt use assets must be determined as of the last day of each taxable year for which a valuation must be made. In contrast, section 4942(e)(2)(A) provides generally that a

foundation's securities for which market quotations are readily available shall be determined on a monthly basis, and that the values of other assets shall be determined at such times and in such manner as the Secretary shall by regulations prescribe.

Section 53.4942(a)-2(c)(4) provides that a private foundation may use any reasonable method to determine the fair market value on a monthly basis of securities for which market quotations are readily available, as long as such method is consistently used, and provides additional valuation guidelines for assets that are not market securities.

Consistent with the proposed rules for determining whether an asset is used directly in carrying out an institution's exempt purpose, the Treasury Department and the IRS propose that, for purposes of valuing the institution's non-exempt use assets, institutions use rules similar to the rules of section 4942(e) and §53.4942(a)-2(c)(4), with two modifications. First, the phrase "applicable educational institution" is substituted for "private foundation" or "foundation" every place they appear. Second, an institution will have to make such adjustments as are reasonable and necessary to obtain the fair market value of non-exempt use assets as of the last day of the valuation taxable year, rather than any other frequency provided by the section 4942 regulations.

The Treasury Department and the IRS request comments on valuing exempt use assets using the principles of section 4942, as modified by this special timing rule.

2. Determination of Net Investment Income and Basis of Property

A. In General

Section 4968(a) imposes on each applicable educational institution a tax equal to 1.4 percent of its net investment income for the taxable year. Section 4968(c) provides

that net investment income is determined under rules similar to the rules of section 4940(c). Accordingly, the proposed regulations provide in §53.4968-1(b) that an institution must calculate its net investment income under the rules of section 4940(c) and §53.4940-1(c) through (f), with certain modifications explained in part 2(B) of this Explanation of Provisions section.

Section 4940(c)(1) defines net investment income as the amount by which the sum of the gross investment income and the capital gain net income exceeds certain specified allowable deductions. Section 4940(c)(1) also states that, except to the extent inconsistent with the provisions of section 4940, net investment income is determined under the principles of subtitle A of the Code.

Section 4940(c)(2) provides that, for purposes of section 4940(c)(1), gross investment income means the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not including any such income to the extent included in computing the unrelated business income tax imposed by section 511. The term gross investment income also includes income from sources similar to those specifically listed in the preceding sentence.

Section 4940(c)(3) provides that, for purposes of section 4940(c)(1), there is allowed as a deduction all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the following modifications: (1) the deduction provided by section 167 is allowed, but only on the basis of the straight line method of depreciation; and (2) the

deduction for depletion provided by section 611 is allowed, but is determined without regard to section 613 (relating to percentage depletion).

Section 4940(c)(4) provides that, for purposes of determining capital gain net income under section 4940(c)(1), (1) no gain or loss from the sale or other disposition of property is taken into account to the extent that any such gain or loss is taken into account for purposes of computing the tax imposed by section 511 on unrelated business taxable income; (2) in the case of property held by a private foundation on December 31, 1969, and continuously thereafter to the date of its disposition, the basis for determining gain is deemed to be not less than the fair market value of such property on December 31, 1969; (3) losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, without capital loss carryovers or carrybacks; and (4) except to the extent provided by regulation, under rules similar to the rules of section 1031 (including the exception under subsection (a)(2) thereof relating to exchanges of real property held primarily for sale), no gain or loss is taken into account with respect to any portion of property used for a period of not less than 1 year for a purpose or function constituting the basis of the private foundation's exemption if the entire property is exchanged immediately following such period solely for property of like kind which is to be used primarily for a purpose or function constituting the basis for such foundation's exemption.

Section 4940(c)(5) provides that, for purposes of section 4940, net investment income is determined by applying section 103 (relating to State and local bonds) and section 265 (relating to expenses and interest relating to tax-exempt income).

Section 4968 does not expressly provide that the tax on net investment income is limited to net investment income derived from assets that are not used directly in carrying out an applicable educational institution's exempt purpose. This lack of a limitation is in contrast to the specific language in section 4968(b)(1)(D) that excludes assets used directly in carrying out an institution's exempt purpose in determining whether the educational institution is an applicable educational institution. Instead, section 4968(c) provides that net investment income shall be determined under rules similar to the rules of section 4940(c). Accordingly, these proposed regulations adopt the rules provided in section 4940(c) and the regulations thereunder, including §53.4940-1(d)(1), which specifies that "gross investment income" means the gross amounts of income from interest, dividends, rents, royalties (including overriding royalties), and capital gain net income received by a private foundation from all sources, but does not include such income to the extent included in computing the tax imposed by section 511. Under this definition, consistent with specific language in §53.4940-1(d), interest, dividends, rents, and royalties derived from assets devoted to charitable activities are includible in gross investment income. Therefore, for example, interest received on a student loan would be includible.

The Treasury Department and the IRS request comments on whether specific types of income should be excluded from gross investment income under section 4968 because taxing those types of income would not achieve the congressional intent in enacting section 4968. In explaining why each such type of income should be excluded, please state specifically how the proposed exclusion is still "similar to" the rules of section 4940(c) and the specific characteristics of each type of such income that

would warrant deviating from the rules provided in section 4940 and the regulations thereunder.

For example, the rules of section 4940(c) specifically include student loan interest as net investment income. However, the Treasury Department and the IRS recognize that student loans provided directly by an applicable educational institution to its students can be seen as helping the applicable educational institution fulfill its mission of educating its students. Unlike private foundations, colleges and universities educate students and charge tuition as part of their primary exempt activities. Student loans provided by an applicable educational institution to its students arguably can be viewed as a form of deferred tuition which will be paid when the student enters the workforce. Under this rationale, the interest on the student loan may arguably be distinguished from investment income, depending on the interest rate. If the interest is at a market (or higher) rate, it would be difficult to distinguish the interest on the student loan and interest on assets acquired for investment purposes. However, if the interest rate is set at a substantially below-market rate, the difference between the market interest rate and the interest rate on the student loan might be viewed as similar to a scholarship from the school to the student. Under these circumstances, the remaining, below-market rate interest income might be considered distinguishable from income derived from assets acquired primarily for investment purposes.

Any exception for student loan interest that is premised on the utilization of an interest rate that is substantially lower than a market rate would potentially present tax administrative challenges for both the IRS and taxpayers in determining the relevant market-rate and an acceptable lower rate, and in adjusting to rate changes during the

course of the loan. Comments advocating an exception for the interest received on student loans should explain how these concerns could be addressed. It would be helpful if such comments also provide information regarding the number of student loans applicable educational institutions make each year, how they set the interest rates on those loans, and whether the rates are set below market, or at market rates.

Allowing an exception from net investment income for certain categories of student loan interest would raise the question of why only those categories of exempt function income are excluded from net investment income. Many other categories of income derived from exempt functions also help an applicable educational institution fulfill its exempt purposes. Private foundations might also argue that many of their types of income help them fulfill their exempt purposes. The Treasury Department and the IRS request comments on why interest income on student loans provided by an applicable educational institution to its students is a logical place to draw the line at the type of income that should be excluded from the net investment income tax, especially given the reference to student loan income in §1.4940-1(d).

Similarly, under section 4940(c), net investment income includes rents. The Treasury Department and the IRS recognize that colleges and universities offer various types of housing (such as dormitories or apartments) for use by students, non-students (for example, during the summer), and faculty. The Treasury Department and the IRS request comments on the differences, if any, among the housing arrangements, whether any of the arrangements include the signing of leases, the various amounts charged by a college or university related to provision of housing and meals, and

particular factors that distinguish room and board payments from students living in a dormitory from rental income that institutions receive.

Consistent with the requirement in section 4968(c) to calculate net investment income under rules similar to the rules under section 4940(c), these proposed regulations generally follow the rules for determining gain upon the sale or other disposition of property that have been used for section 4940(c) purposes since 1969. Section 4940(c)(1) provides that, except to the extent inconsistent with the provisions of section 4940, net investment income is determined under the principles of subtitle A. Subtitle A encompasses all of the income tax provisions (sections 1 through 1564) of the Code, including the basis rules in section 1015 (basis of property acquired by gift is generally the same as the donor's basis). Accordingly, under the proposed regulations, an applicable education institution computes gain on the sale or disposition of donated property using the donor's basis. The Treasury Department and the IRS request comments on whether a special rule excluding any appreciation in a gift of donated property that occurred before the date of receipt by the applicable educational institution should be included in the final regulations and how such a special rule would be consistent with the statutory language of section 4968.

B. Special Rules

The proposed regulations provide in §53.4968-1(b)(3) that an institution should substitute "applicable educational institution" for "private foundation" or "foundation" every place it appears in §53.4940-1(c) through (f). In addition, the proposed regulations provide that the rule in §53.4940-1(d)(3) does not apply because it is narrowly focused on section 302 stock redemptions by corporations that are disqualified

persons when the redemptions are part of a transaction designed to reduce section 4943 excess business holdings. Colleges and universities are not subject to section 4943, so they cannot have excess business holdings that could be the subject of a section 302 stock redemption by a disqualified person corporation.

As provided by section 3 of Notice 2018-55 (2018-26 I.R.B. 773), in following the rule in section 4940(c)(4), the proposed regulations substitute “December 31, 2017” for “December 31, 1969” every place it occurs. In addition, in response to a comment requesting clarification of the basis rules for assets held in a partnership on December 31, 2017, these proposed regulations also provide that if an applicable educational institution held an interest in a partnership (including through one or more tiers of partnerships) on December 31, 2017, and continuously thereafter, and the partnership held assets on December 31, 2017, and continuously thereafter to the date of disposition, the partnership’s basis in its assets with respect to the applicable educational institution for purposes of determining the applicable educational institution’s share of gain upon sale or disposition of the assets shall be not less than the fair market value of such asset on December 31, 2017, plus or minus all adjustments after December 31, 2017, and before the date of disposition. For purposes of applying this special partnership basis rule, an institution must obtain documentation from the partnership to substantiate the claim.

Finally, consistent with section 4 of Notice 2018-55 and section 4940(c)(4)(C), the proposed regulations provide that in applying §53.4940-1(f), overall net losses from sales or other dispositions of property by one related organization (or by the applicable educational institution) shall reduce (but not below zero) overall net gains from such

sales or other dispositions by other related organizations (or by the applicable educational institution).

3. Related Organizations

Section 4968(d)(1) provides, in part, that for purposes of determining 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 with respect to the educational institution shall be treated as assets and net investment income, respectively, of the educational institution.

For this purpose, the statute provides two special rules: (1) no such amount shall be taken into account with respect to more than 1 educational institution, and (2) unless such organization is controlled by such institution or is described in section 509(a)(3) (relating to supporting organizations) with respect to such institution for the taxable year, assets and net investment income which are not intended or available for the use or benefit of the educational institution shall not be taken into account. Section 53.4968-1(c) of these proposed regulations provides definitions and special rules relating to related organizations.

A. Definition of Related Organization

Section 4968(d)(2) provides that the term “related organization” means, with respect to an applicable educational institution, any organization which (1) controls, or is controlled by, such institution; (2) is controlled by 1 or more persons which also control such institution; or (3) is a supported organization (as defined in section 509(f)(3)) or a supporting organization (as described in section 509(a)(3)) during the taxable year with respect to such institution.

Section 4968(d)(2) does not define the term “control.” The concept of controlled entities is found in numerous other areas of the Code, including section 4960, which was enacted at the same time as section 4968. Consistent with the position taken in Notice 2019-09, “Interim Guidance Under Section 4960” (2019-04 I.R.B. 403), for purposes of defining “control” within the meaning of section 4968(d), these proposed regulations provide rules based on the definition of control under section 512(b)(13)(D) and the regulations thereunder, which includes the constructive ownership rules of section 318, and that generally align with the definition of related organization for purposes of the annual reporting requirements on Form 990. The Treasury Department and the IRS request comments on whether there are any circumstances in which this definition of control should be modified in the context of section 4968.

Thus, the proposed regulations provide in §53.4968-1(c)(1) that the term “control” means (1) in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of the corporation; (2) in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership; (3) in the case of a trust with beneficial interests, ownership of more than 50 percent of the beneficial interests in the trust; or (4) in the case of a nonprofit organization or other organization without owners or persons having beneficial interests (nonstock organization), including a governmental entity, that more than 50 percent 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 that more than 50 percent of the directors or trustees of the nonstock organization are either representatives of, or are directly or indirectly controlled by, one or more persons

that control the applicable educational institution. For purposes of this paragraph, a “representative” means a trustee, director, agent, or employee, and control includes the power to remove a trustee or director and designate a new trustee or director. Finally, 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. The Treasury Department and the IRS do not propose to adopt the test for control under section 414(b) and (c), which generally uses the same test for control of a nonprofit organization as section 512(b)(13)(D) except that it replaces the 50-percent threshold with an 80-percent threshold. Instead, the proposed regulations adopt the control test under section 512(b)(13)(D) to align more closely with other exempt organization control tests and to ensure consideration of available assets consistent with congressional intent that would not occur under the higher 80 percent control threshold that was established for qualified plans.

Since the net investment that a taxable entity provides to an applicable educational institution has already been taxed under section 1, the Treasury Department and the IRS do not consider it consistent with congressional intent to tax the income again under section 4968. Furthermore, with regard to the assets of a taxable entity that is a related organization defined in section 4968(d)(2)(A) or (B), the institution likely already has included the value of the stock in its non-exempt use assets; however, the stock value may differ from the value of the taxable entity’s underlying assets. The Treasury Department and the IRS request comments on how to account for this difference without double-counting the assets, as well as comments on

the treatment of taxable entities that are related organizations for purposes of section 4968.

B. Assets and Net Income Treated as Assets and Net Income of Only One Educational Institution

As noted above, section 4968(d)(1)(A) provides, in part, that for purposes of determining the aggregate fair market value of an institution's assets and its net investment income, the assets and net investment income of any related organization with respect to the educational institution shall be treated as assets and net investment income, respectively, of the educational institution. However section 4968(d)(1)(A) provides an exception under which no such amount shall be taken into account with respect to more than 1 educational institution.

In order to effectuate section 4968(d)(1)(A), the proposed regulations provide in §53.4968-1(c)(2)(ii)(A) that, in any case in which an organization is a related organization with respect to more than 1 educational institution, the assets and net investment income of the related organization must be allocated between the educational institutions being supported by the related organization. The proposed regulations provide that such allocation must be made in a reasonable manner, taking into account all facts and circumstances, and must be consistently applied across all related organizations. The Treasury Department and the IRS request comments on whether more specific guidance is required concerning the allocation of a related organization's assets and net investment income between multiple educational institutions being supported by the same related organization, and if so, what such additional guidance should provide.

C. Assets and Net Investment income “Not Intended or Available for the Use or Benefit of” an Educational Institution

For purposes of attributing assets and net investment income of related organizations to applicable educational institutions, section 4968(d)(1)(B) provides that, unless a related organization is controlled by the educational institution or is described in section 509(a)(3) with respect to such institution for the taxable year, assets and net investment income of the related organization that are not intended or available for the use or benefit of the educational institution shall not be taken into account. Put another way, if a related organization controls the educational institution or is controlled by 1 or more persons which also control such institution but is not described in section 509(a)(3) with respect to the educational institution for the taxable year, then the assets and net investment income of the related organization are taken into account as assets and net investment income of the educational institution only if the assets and net investment income are intended or available for the use and benefit of the educational institution. However, if a related organization is either controlled by the educational institution or is described in section 509(a)(3) with respect to such institution for the taxable year, then all the assets and net investment income of the related organization are considered assets and net investment income of the educational institution, except as provided below.

The Conference Report description of section 4968 repeats section 4968(d)(1)(B) and adds, “[f]or example, 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.” H. Rept. 115-466, 115th Cong., 1st sess., at 555 (December 15, 2017).

Thus, the proposed regulations provide in §53.4968-1(c)(2)(ii)(B) that when a related organization controls an educational institution or is controlled by 1 or more persons which also control such institution and is not described in section 509(a)(3) with respect to the educational institution, the assets and net investment income of a related organization must be allocated between those intended or available for the use and benefit of an educational institution and those not intended or not available for the use and benefit of that educational institution. Such allocation must be made in a reasonable manner, taking into account all facts and circumstances, and must be consistently applied across all related organizations.

The proposed regulations further explain that assets and net investment income of such a related organization are intended or available for the use and benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for the benefit of, or are otherwise fairly attributable to, the educational institution. Conversely, assets and net investment income of a related organization are not intended or available for the use and benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for another entity or for unrelated purposes or are otherwise not fairly attributable to the educational institution. For purposes of this required allocation, the Treasury Department and the IRS request comments on situations in which an organization’s assets or net investment income is not specifically earmarked or

restricted for the benefit of any particular organization but is otherwise fairly attributable to the educational institution or to another organization. For example, absent any earmarking or restriction, should total distributions from a related organization to an applicable educational institution in one taxable year establish a presumption for section 4968 purposes that at least an equal amount is fairly attributable to the applicable educational institution for the following taxable year, absent demonstrated facts and circumstances supporting attribution of a lesser amount?

Because section 4968(d)(1)(B) carves out organizations that are controlled by an institution or are described in section 509(a)(3) with respect to such institution for the taxable year from this special rule, the proposed regulations provide that if the related organization is controlled by the educational institution or is described in section 509(a)(3) with respect to the educational institution, the assets and net investment income of the related organization must be taken into account as assets and net investment income of the educational institution, regardless of whether the assets and net investment income are earmarked or restricted for the benefit of, or otherwise fairly attributable to, the educational institution and even if they are specifically earmarked or restricted for another entity or for unrelated purposes or are otherwise not fairly attributable to the educational institution. However, the special rule in section 4968(d)(1)(A) continues to apply, such that the assets and net investment income of the related organization are not taken into account by more than one educational institution. See part 3(B) of the Explanation of Provisions section.

In recognition that section 509(a)(3) Type III supporting organizations, unlike section 509(a)(3) Type I and Type II supporting organizations, are not controlled by their

supported organizations,³ and because applicable educational institutions may not be able to get information from their Type III supporting organizations, the proposed regulations provide a special rule in §53.4968-1(c)(2)(ii)(B)(3)(ii) for related organizations of an educational institution that were Type III supporting organizations with respect to the applicable educational institution on December 31, 2017. The proposed regulations provide that an applicable educational institution with a related organization that was a Type III supporting organization with respect to the applicable educational institution on December 31, 2017, may take into account only the assets and net investment income of the related Type III supporting organization that are intended or available for the use and benefit of the applicable educational institution, as described in this part 3(C) of the Explanation of Provisions section. An applicable educational institution can determine whether the assets and net investment income of such a Type III supporting organization are intended or available for the use and benefit of the applicable educational institution using any reasonable method. A method using all the distributions received from the Type III supporting organization subject to this special rule as net investment income of the applicable educational institution each year will be deemed to be reasonable. Similarly, a method using the distributions received

³ Organizations described in section 509(a)(3) are known as “supporting organizations.” Supporting organizations achieve their public charity status by providing support to one or more organizations described in section 509(a)(1) or (2), which, in this context, are referred to as “supported organizations.” To be described in section 509(a)(3), an organization must satisfy several tests, including having one of three “relationships” with one or more supported organizations. A supporting organization that is operated, supervised or controlled by one or more supported organizations is known as a “Type I” supporting organization. A supporting organization that is supervised or controlled in connection with one or more supported organizations is known as a “Type II” supporting organization. A supporting organization that is operated in connection with one or more supported organizations is known as a “Type III” supporting organization. The relationship of a Type III supporting organization with its supported organization(s) is much more attenuated than the other two types.

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 applicable educational institution, and using 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 applicable educational institution each year, will be deemed to be reasonable. The Treasury Department and the IRS request comments on whether additional guidance pertaining to Type III supporting organizations is needed.

Special Analyses

Executive Orders 12866 and 13563 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

The proposed regulations have been designated by the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and OMB regarding review of tax regulations. OIRA has determined that the proposed rulemaking is significant and subject to review under Executive Order 12866 and section 1(b) of the Memorandum of Agreement. Accordingly, the proposed regulations have been reviewed by OMB.

I. Need for Regulation

The Conference Report, at 555, states that Congress intended that the Secretary promulgate regulations to carry out the intent of section 4968. These proposed regulations are in response to this congressional intent. The proposed regulations provide guidance for determining the excise tax applicable to the net investment income of certain private colleges and universities, as provided by the TCJA. The regulations are intended to clarify which educational institutions are subject to the excise tax under section 4968 (excise tax) and how net investment income is calculated for purposes of this excise tax.

Prior to these proposed regulations, the Treasury Department and the IRS have not issued formal guidance on the definitions of these terms or on the rules under which net investment income for purposes of the excise tax in section 4968 were determined.⁴ As a result, there was a degree of taxpayer uncertainty as to the definitions of the various terms and whether net investment income would be determined under rules identical to or similar to the rules of section 4940(c), and if the latter, what the deviations from the rules of section 4940(c) would be.

Pursuant to section 6(a)(3)(B) of Executive Order 12866, the following qualitative analysis provides further details regarding the anticipated impacts of the proposed regulations. After describing briefly the statute and the proposed regulations in Part II, the baseline used for the analysis is described in Part III of this Special Analyses

⁴ In June 2018, the Treasury Department and the IRS issued Notice 2018-55 (2018-26 I.R.B. 773) to provide clarification regarding the calculation of net investment income for purposes of section 4968(c). The Notice stated that the Treasury Department and the IRS intended to issue proposed regulations relating to those and other issues.

section. Part IV of this Special Analyses section describes the types of entities affected by the proposed regulations. Part V of this Special Analyses section provides a qualitative assessment of the potential economic effects, including the benefits and costs, of the proposed regulations compared to the baseline.

II. The Statute and the Proposed Regulations

Section 4968 imposes a 1.4 percent excise tax on the net investment income of applicable educational institutions. Under the statute, an “applicable educational institution” is an eligible educational institution (which is described in section 481 of the Higher Education Act of 1968) that has at least 500 tuition-paying students during the preceding taxable year, more than 50 percent of the tuition-paying students of which are located in the United States, is not a state college or university, and the fair market value of the assets of which (other than those assets which are used directly in carrying out the institution’s exempt purpose) is at least \$500,000 per student at the end of the preceding taxable year. Under section 4968, net investment income is determined under rules “similar to” the rules of section 4940(c) (the rules for calculation of the net investment income of private foundations). In addition, the assets and net investment income of related organizations are generally treated as the assets and net investment income of the educational institution.

Section 4968 does not define the terms “student,” “tuition-paying student,” or “assets used directly in carrying out the institution’s exempt purpose.” Section 4968(c) states that, for the purposes of the excise tax in section 4968, net investment income shall be determined under rules “similar to” the rules of section 4940(c), but does not define what is meant by “similar to.” Section 4968 does not define the term “control” as

it relates to a “related organization with respect to an educational institution.” The proposed regulations provide general definitional guidance with respect to these and other terms and rules relevant to the statute. A brief discussion of this guidance follows.

The proposed regulations define “student” to mean, in general, “a person enrolled in a degree, certification, or other program (including a program of study abroad approved for credit by the eligible institution at which such student is enrolled) leading to a recognized educational credential at an institution, and who is not enrolled in an elementary or secondary school.” The proposed regulations define “tuition-paying” to mean, in general, “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.” These definitions follow similar definitions in section 25A of the Code. The proposed regulations also provide guidance for determining whether a student is located in the U.S. and for counting full-time and full-time equivalent students.

The proposed regulations define “assets used directly in carrying out an institution’s exempt purpose” to mean, in general, assets “actually used by the institution in carrying out its exempt purpose.” Whether an asset qualifies “must be determined based on all the facts and circumstances.” If the property’s “exempt use represents 95 percent or more of the total use, the property is considered to be used exclusively for an exempt purpose. If the exempt use of such property represents less than 95 percent of the total use, the institution must make a reasonable allocation between such exempt and nonexempt uses.”

The proposed regulations state that the valuation of assets not used directly in carrying out an institution’s exempt purpose is determined under the rules of section

4942 and its regulations, with two modifications. First, “educational institution” is substituted for “private foundation” or “foundation” each place they appear. Second, the educational institution must obtain the fair market value of assets on the last day of the preceding taxable year rather than at other times provided by the regulations under section 4942.

Consistent with 4968(c), the proposed regulations state that net investment income will be determined under the rules of section 4940(c) and its regulations, with five modifications. First, “applicable educational institution” is substituted for “private foundation” or “foundation” each place they appear. Second, the regulations relating to the treatment of certain distributions in redemption of stock do not apply to applicable educational institutions. Third, December 31, 2017, replaces December 31, 1969 (the date used for the excise tax on net investment income of private foundations under section 4940(c)), to determine the basis of assets held on December 31, 2017, for purposes of calculating the excise tax. Fourth, if an applicable educational institution held an interest in a partnership on December 31, 2017, and continuously thereafter, and the partnership held assets on December 31, 2017, and continuously thereafter to the date of disposition, generally the basis of those assets for determining the applicable educational institution’s share of gain upon sale or disposition of the assets is not less than the fair market value of such assets on December 31, 2017, plus or minus adjustments provided under the regulations for section 4940 after December 31, 2017, and before the date of disposition. Fifth, overall net losses from sales or other dispositions of property by one related organization or by the applicable educational

institution may reduce (but not below zero) overall net gains from such sales or other dispositions by other related organizations or by the applicable educational institution.

Following the rules for section 4960, the proposed regulations define the term “control,” as it relates to a “related organization with respect to an educational institution,” generally to mean ownership of more than 50 percent of (a) the stock of a corporation, (b) the profits interests or capital interests in a partnership, or (c) the beneficial interests of a trust. For a nonstock corporation, control means (a) more than 50 percent 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 (b) more than 50 percent of the directors or trustees are representatives of, or are directly or indirectly controlled by, one or more persons that control the applicable educational institution. The proposed regulations apply the principles of section 318 for purposes of determining ownership of stock in a corporation and apply similar principles for purposes of determining ownership of an interest in any other entity.

The proposed regulations also provide an allocation rule to effectuate section 4968(d)(1)(A) (providing that income be taken into account by no more than one institution) and 4968(d)(1)(B) (providing that only assets available for use by the institution be taken into account in determining the aggregate amount of assets), in the case of related organizations.

III. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

IV. Affected Entities

One researcher used data from the Integrated Post-Secondary Education Data System (IPEDS) on endowment values at the end of the 2015-2016 academic year and enrollment data to estimate the number of institutions at risk of having liability under this excise tax.⁵ Under the assumption that none of the assets in the endowment are for exempt purposes, he estimates that 23 institutions are likely to be currently subject to tax. Using the same IPEDS data, another researcher estimated that in 2016, among four-year public and not-for-profit private institutions located in the United States with at least 500 full-time equivalent students, and excluding endowments held at the university system level, there were 27 endowments worth at least \$500,000 per student.⁶ These estimates do not take into account all of the provisions of the statute and regulations. For example, limiting this set of institutions to the not-for-profit private institutions subject to tax and excluding assets that are used for the institutions' exempt purpose would reduce the number of affected institutions. On the other hand, as both authors note, because the \$500,000 per student threshold for the aggregate fair market value of assets (other than those assets which are used directly in carrying out the institution's

⁵ Levine, Phillip. "The University Endowment Income Tax: Who Will Pay it and Why Was it Implemented?", Econofact, January 25, 2018, available at <https://econofact.org/the-university-endowment-tax-who-will-pay-it-and-why-was-it-implemented>, accessed April 29, 2019.

⁶ Hinrichs, Peter. "College Endowments." Economic Commentary 2018-04 (May 17, 2018), Federal Reserve Bank of Cleveland, Table 1.

exempt purpose) that in part determines whether the excise tax in section 4968 applies to an educational institution is not indexed for inflation, the number of institutions to which the excise tax in section 4968 applies is expected to increase over time. In addition, these studies did not consider assets held by related organizations; including such assets could increase the number of affected schools.

V. Economic Effects of the Proposed Regulations

The proposed regulations clarify a number of definitions related to the excise tax in section 4968. In the absence of guidance, affected taxpayers would have to calculate their tax liability without the definitions and clarifications provided by the proposed regulations, a situation that is generally considered more burdensome and could lead to greater conflicts with tax administrators. The proposed regulations make use of a number of existing statutory and regulatory provisions in defining students, tuition, exempt purpose, fair market value, net investment income and related organizations. Many taxpayers will already be familiar with these definitions. Thus, although the Treasury Department and the IRS project that the proposed regulations will reduce taxpayer compliance burden, including determining whether the excise tax applies to the institution and the time needed to file the return, and the costs of tax administration, including monitoring the compliance of taxpayers with the excise tax, relative to the no-action baseline, it is possible that the proposed regulations will have other economic effects.

The guidance provided in the proposed regulations also ensures that the excise tax liability is calculated similarly across taxpayers, avoiding situations where one taxpayer receives preferential treatment over another taxpayer for fundamentally similar

economic activity. For example, in the absence of these proposed regulations, an applicable educational institution may have uncertainty over whether it is subject to the excise tax under section 4968 and what assets are used in determining the net investment income for purposes of the excise tax under section 4968. As a result, in the absence of guidance, similar institutions might take different positions and pay different amounts of tax, introducing economic inefficiency and inequity.

Based on this analysis, the Treasury Department and the IRS anticipate the net economic contribution of the proposed regulations will be modest, and will be positive relative to not issuing any such guidance and conditional on the relevant statutes. However, as stated earlier in the preamble, the Treasury Department and the IRS request comments on a number of aspects of the proposed regulations, which could include comments on the economic effects, any behavioral changes caused, or the unintended costs and benefits of the proposed regulations.

These proposed regulations provide further clarity on the Treasury Department and IRS policy choices regarding the treatment of investment income under section 4968, including the relationship to section 4940(c). Treasury Department and IRS requests comment on the proposed definitions and treatment of investment income in these regulations.

Paperwork Reduction Act

The collection of information in these proposed regulations is in §§53.4968-1(a)(2), (3), and (4), and 53.4968-1(b) and (c)(1) and (2). This information is required to determine whether an educational institution is an applicable educational institution, as defined in section 4968(b); to calculate net investment income as defined in section

4968(c); and to determine the assets and net investment income of related organizations that are treated as assets and net investment income of applicable educational institutions, as defined in section 4968(d). In 2016, the IRS released and invited comments on drafts of an earlier version of Form 4720 in order to give members of the public the opportunity to benefit from certain specific amendments made to the Code. The IRS received no comments on Form 4720 during the comment period. Consequently, the IRS made Form 4720 available on December 9, 2016 for use by the public. The IRS is contemplating making additional changes to Form 4720 based on these regulations. The IRS intends that the burden of the collections of information will be reflected in the burden associated with Form 4720, OMB approval number 1545-0052.

The burden associated with Form 4720 is included in the aggregated burden estimates for OMB control number 1545-0052 (listing a total estimated burden time for all Form 4720 filers of 88,839 hours and total estimated monetized costs of \$8.441 million (\$2017)). The burden estimates provided for Form 4720 are aggregate amounts that relate to all filers associated with the form, and will in the future include, but not isolate, the estimated burden of only those information collections associated with these proposed regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by these regulations, specific burden estimates for which are not currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations.

The expected burden for private colleges and universities that are applicable to this rule as described in section 4968(b) is listed below:

Estimated number of respondents: 40

Estimated average annual burden hours per response: 32 hours, 27 minutes

Estimated total annual burden: \$123,336 (2017)

Estimated frequency of collection: Annual

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections contained in these final regulations will be made available for public comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the PRA. Comments on these forms can be submitted at <https://www.irs.gov/forms-pubs/comment-on-tax-forms-and-publications>.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities. As discussed elsewhere in this preamble, this rule merely provides definitions regarding the applicability of the section 4968 excise tax to certain private colleges and universities. The requirements in this regulation fall only on educational institutions the aggregate fair market values of the non-charitable use assets of which are at least \$500,000 per student of the institution and that have at least 500 tuition-paying students (for a minimum investment asset value of \$250,000,000).

This proposed rule would not affect a substantial number of small entities. Only about 1 percent of four-year colleges and universities (less than 30 out of over 2,400 institutions in the National Center for Education Statistics' Integrated Post-Secondary Education System Data for 2016) are expected to be affected by the tax. In addition, they are likely to have income from all sources exceeding \$27.5 million, the threshold established by the Small Business Administration for an educational institution to be considered a small entity. This is because at a modest 4 percent rate of return, the minimum endowment alone would generate income of \$10 million. To generate another \$17.5 million in income would require receipts of \$35,000 per student if the school had only the minimum number of students, compared to average tuition and fees at a four-

year private school, which was \$39,529⁷ in 2015-16. Therefore, this rule is not likely to affect a substantial number of small entities.

Notwithstanding this certification, the Treasury Department and the IRS invite comments on the impact this rule may have on small entities.

Pursuant to section 7805(f) of the Code, this proposed rule has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are timely submitted to the IRS as prescribed in the preamble under the **ADDRESSES** section. All comments submitted will be made available at <https://www.regulations.gov> or upon request.

A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Melinda Williams and Amber L. MacKenzie, Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Tax). However, other personnel from the Treasury Department and the IRS participated in their development.

Statement of Availability of IRS Documents

⁷ U.S. Department of Education, National Center for Education Statistics (2018). Digest of Education Statistics, 2016 (NCES 2017-094).

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

List of Subjects in 26 CFR Part 53

Excise taxes, Foundations, Investments, Lobbying, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 53 is proposed to be amended as follows:

PART 53--FOUNDATION AND SIMILAR EXCISE TAXES

Paragraph 1. The authority citation for part 53 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 53.4968-1 is added to read as follows:

§53.4968-1 Excise tax based on investment income of certain private colleges and universities.

(a) Excise tax on the investment income of certain private colleges and universities--(1) In general. For taxable years beginning after December 31, 2017, section 4968 imposes a tax equal to 1.4 percent of the net investment income (as defined in section 4968(c) and paragraph (b) of this section) of an applicable educational institution (as defined in section 4968(b)(1) and paragraph (a)(2) of this section).

(2) Applicable educational institution. Under section 4968(b)(1) and for purposes of this section, the term *applicable educational institution* means any eligible educational institution as defined in section 25A(f)(2) and §1.25A-2(b) of this chapter--

(i) Which had at least 500 tuition-paying students attending the institution during the preceding taxable year;

(ii) More than 50 percent of the tuition-paying students attending the institution are located in the United States;

(iii) Which is not described in the first sentence of section 511(a)(2)(B) (relating to state colleges and universities); and

(iv) The aggregate fair market value of the assets of which at the end of such preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purpose) is at least \$500,000 per student attending the institution.

(3) Student--(i) In general. For purposes of section 4968 and paragraph (a) of this section, the term *student* means a person enrolled in a degree, certification, or other program (including a program of study abroad approved for credit by the eligible institution at which such student is enrolled) leading to a recognized educational credential at an institution, and who is not enrolled in an elementary or secondary school.

(ii) Tuition-paying--(A) In general. For purposes of section 4968 and paragraph (a) of this section, the term *tuition-paying* means 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. The term *tuition-paying* does not include payment for supplies or equipment required during a specific course once a student is enrolled in

and attending the course or the payment of room and board or other personal living expenses.

(B) Treatment of a comprehensive or bundled fee. If a student is required to pay a fee (such as a comprehensive fee or a bundled fee) to an educational institution that combines charges for tuition with charges for personal expenses such as room and board, the student is a tuition-paying student.

(C) Scholarships and work study programs operated directly by the applicable educational institution. Whether a student is tuition-paying is determined after taking into account any scholarships provided directly by the educational institution and any work study programs operated directly by the institution. Scholarship payments provided by third parties, even if administered by the institution, are considered payments of tuition on behalf of the student. Accordingly, a student will be considered a tuition-paying student if payment of tuition or a fee is required for the enrollment or attendance of the student for courses of instruction after the application of any scholarships offered directly by the institution or work study program operated directly by the institution.

(iii) Located in the United States. For purposes of section 4968 and paragraph (a) of this section, the term *located in the United States* refers to the location of a student. 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 the student attended the institution during the applicable educational institution's preceding taxable year.

(iv) Full-time/part-time students. For purposes of section 4968 and paragraph (a) of this section, the number of students of an educational institution (including for purposes of determining the number of students at a particular location) is based on the daily average number of full-time students attending such institution (with part-time students taken into account on a full-time student equivalent basis). The standards for determining part-time students, full-time students, full-time equivalents, and daily average are determined by each educational institution. However, the standards may not be lower than the applicable standards established by the Department of Education under the Higher Education Act of 1965 (20 U.S.C. 1088).

(4) Assets used directly in carrying out an institution's exempt purpose--(i) In general. For purposes of section 4968 and this paragraph (a)(4), an asset is used directly in carrying out an educational institution's exempt purpose only if the asset is actually used by the institution in carrying out its exempt purpose. Whether an asset is used directly by the institution to carry out its exempt purpose must be determined based on all the facts and circumstances. If property is used for an exempt purpose and for other purposes, and the exempt use represents 95 percent or more of the total use, the property is considered to be used exclusively for an exempt purpose. If the exempt use of such property represents less than 95 percent of the total use, the institution must make a reasonable allocation between such exempt and nonexempt uses.

(ii) Illustrations. Examples of assets that are used directly in carrying out an institution's exempt purpose include, but are not limited to, the following--

(A) Administrative assets, such as office equipment and supplies used by the institution directly in the administration of its exempt activities;

(B) Real estate or the portion of any building used by the institution directly in its exempt activities;

(C) Physical property such as paintings or other works of art owned by the institution which are on public display, fixtures and equipment in classrooms, research facilities and related equipment which under the facts and circumstances serve a useful purpose in the conduct of the institution's exempt activities;

(D) The reasonable cash balances necessary to cover current administrative expenses and other normal and current disbursements directly connected with the educational institution's exempt activities. For purposes of this paragraph (a)(4)(ii)(D), the portion of an educational institution's actual cash balances at the end of a year that does not exceed 1.5 percent 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 to be a reasonable cash balance; and

(E) 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 purposes.

(iii) Exceptions. The following assets are examples of assets not used directly in carrying out an institution's exempt purpose--

(A) 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

(B) Property (such as offices) used for the purpose of managing the institution's endowment funds.

(iv) Valuation of assets not used directly in carrying out an institution's exempt purpose--(A) In general. The valuation of assets not used directly in carrying out an institution's exempt purpose is determined under the rules of section 4942(e) and §53.4942(a)-2(c)(4), as modified by paragraph (a)(4)(iv)(B) of this section.

(B) Special rules. In applying the rules of §53.4942(a)-2(c)(4), an educational institution must--

(1) Substitute "educational institution" for "private foundation" or "foundation" every place they appear; and

(2) Make such adjustments as are reasonable and necessary to obtain the fair market value of any and all assets as of the last day of the preceding taxable year, rather than any other times permitted or required by §53.4942(a)-2(c)(4).

(b) Net investment income--(1) In general. An applicable educational institution described in paragraph (a)(2) of this section is subject to the 1.4 percent tax on its net investment income, and, as described in paragraph (c) of this section, also on certain amounts of net investment income of certain related organizations, for the taxable year.

(2) Calculation of net investment income. For purposes of paragraph (b)(1) of this section, net investment income will be determined under the rules of section 4940(c) and §53.4940-1(c) through (f), as modified by paragraph (b)(3) of this section.

(3) Special rules. In applying §53.4940-1(c) through (f):

(i) Substitute "Applicable educational institution" for "private foundation" and "foundation" each place they appear.

(ii) Section 53.4940-1(d)(3), relating to certain distributions in redemption of stock, does not apply.

(iii) Substitute “December 31, 2017” for “December 31, 1969” each place it appears.

(iv) If an applicable educational institution held an interest in a partnership (including through one or more tiers of partnerships) on December 31, 2017, and continuously thereafter, and the partnership held assets on December 31, 2017 and continuously thereafter to the date of disposition, the partnership’s basis in its assets with respect to the applicable educational institution for purposes of determining the applicable educational institution’s share of gain upon sale or disposition of the assets is not less than the fair market value of such asset on December 31, 2017, plus or minus all adjustments as provided under §53.4940-1(f)(2)(i) after December 31, 2017, and before the date of disposition. To avail itself of this special partnership basis rule, an institution must obtain documentation from the partnership to substantiate the basis used.

(v) For purposes of §53.4940-1(f), overall net losses from sales or other dispositions of property by one related organization (or by the applicable educational institution) reduce (but not below zero) overall net gains from such sales or other dispositions by other related organizations (or by the applicable educational institution).

(c) Related organizations--(1) Definition of related organization--(i) In general.
The term “related organization” means, with respect to an applicable educational institution, any organization which--

(A) Controls, or is controlled by, such institution;

(B) Is controlled by one or more persons which also control such institution; or

(C) Is a supported organization (as defined in section 509(f)(3)) or a supporting organization (as described in section 509(a)(3)) during the taxable year with respect to such institution.

(ii) Control. The term control generally means—

(A) Stock corporation. In the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of the corporation;

(B) Partnership. In the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership; or

(C) Trust. In the case of a trust with beneficial interests, ownership of more than 50 percent of the beneficial interests in the trust.

(D) Nonstock organization. In the case of a nonprofit organization or other organization without owners or persons having beneficial interests (nonstock organization), including a governmental entity, control means that—

(1) More than 50 percent 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

(2) More than 50 percent of the directors or trustees of the nonstock organization are either representatives of, or are directly or indirectly controlled by, one or more persons that control the applicable educational institution. For purposes of this paragraph (c)(1)(ii)(D)(2), a “representative” means a trustee, director, agent, or employee, and control includes the power to remove a trustee or director and designate a new trustee or director.

(iii) Constructive ownership. The principles of section 318 apply for purposes of determining ownership of stock in a corporation, and similar principles apply for purposes of determining ownership of interest in any other entity.

(2) Assets and net investment income of related organizations--(i) In general. For purposes of determining 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 treated as the assets and net investment income, respectively, of the institution unless an exception provided in paragraph (c)(2)(ii) of this section applies.

(ii) Exceptions. For purposes of section 4968 and this paragraph (c)(2)—

(A) No amount taken into account with respect to more than one educational institution. In determining the aggregate fair market value of the assets and net investment income of an educational institution, assets and net investment income of a related organization are not taken into account with respect to more than one educational institution. Thus, in any case in which an organization is a related organization with respect to more than one educational institution, the assets and net investment income of the related organization must be allocated between the educational institutions being supported by the related organization. Such allocation must be made in a reasonable manner, taking into account all facts and circumstances, and must be used consistently across all related organizations.

(B) Not intended or available for the use or benefit of the educational institution—

(1) In general. Except as provided by paragraph (c)(2)(ii)(B)(3) of this section, for purposes of determining the aggregate fair market value of the assets and net

investment income of an educational institution, the assets and net investment income of a related organization are taken into account as assets and net investment income of the educational institution unless the assets and net investment are not intended or available for the use and benefit of the educational institution.

(2) Determining whether assets and net investment income of a related organization are intended or available for the use and benefit of an educational institution. Assets and net investment income of a related organization are intended or available for the use and benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for the benefit of, or are otherwise fairly attributable to, the educational institution. Conversely, assets and net investment income of a related organization are not intended or available for the use and benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for another entity or for unrelated purposes or are otherwise not fairly attributable to the educational institution. The assets and net investment income of a related organization must be allocated between those intended or available for the use and benefit of an educational institution and those not intended or not available for the use and benefit of an educational institution. Such allocation must be made in a reasonable manner, taking into account all facts and circumstances, and must be used consistently across all related organizations.

(3) Organizations controlled by the institution or described in section 509(a)(3) with respect to the institution for the taxable year—(i) In general. If a related organization is controlled, as defined in paragraph (c)(1) of this section, by an educational institution, or is a supporting organization described in section 509(a)(3)

with respect to the educational institution, the assets and net investment income of the related organization are taken into account as assets and net investment income of the educational institution regardless of whether the assets and net investment income are earmarked or restricted for the benefit of, or otherwise fairly attributable to, the educational institution and even if they are specifically earmarked or restricted for another entity or for unrelated purposes or are otherwise not fairly attributable to the educational institution, subject to paragraph (c)(2)(ii)(A) of this section.

(ii) Special rule for Type III supporting organizations with respect to such institution as of December 31, 2017. An educational institution with a related organization that was a Type III supporting organization with respect to the educational institution on December 31, 2017, takes into account only the assets and net investment income of such Type III supporting organization that are intended or available for the use and benefit of, or otherwise fairly attributable to, the educational institution, as described in paragraph (c)(2)(ii)(B)(2) of this section. An educational institution may determine whether the assets and net investment income of such Type III supporting organization are intended or available for the use and benefit of, or otherwise fairly attributable to, the educational institution using any reasonable method. A method treating all the distributions received from such Type III supporting organization as net investment income of the school each year is deemed to be reasonable. Similarly, a method using 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 using 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, will be deemed to be reasonable.

(d) Applicability date. The rules of this section apply to taxable years beginning after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. A taxpayer may rely on these regulations for taxable years beginning before publication of final regulations.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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