NEW YORK STATE BAR ASSOCIATION

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Report No. 1424
October 1, 2019

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

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1424 – Report on Proposed Section 4968 Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1424 commenting on proposed regulations under Internal Revenue Code Section 4968. That Section imposes an annual excise tax of 1.4% of the net investment income of an "applicable educational institution." This Report follows our prior report dated June 7, 2018 which discussed certain provisions that affect exempt organizations, including Section 4968. We commend the Internal Revenue Service and the Department of the Treasury for issuing thoughtful and timely guidance on these topics.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

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Report No. 1424

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED SECTION 4968 REGULATIONS

October 1, 2019

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REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION

This report ("**Report**") [1] of the New York State Bar Association Tax Section comments on proposed regulations (the "**Proposed Regulations**")[2] issued by the Internal Revenue Service ("**IRS**") and the Department of the Treasury ("**Treasury**") under Section 4968[3], as enacted by the Tax Cuts and Jobs Act, P.L. 115-97 (the "**Act**"). That Section imposes an annual excise tax of 1.4 percent on the net investment income of an "applicable educational institution," as defined in Section 4968(b) and, as described in Section 4968(d), a portion of certain net investment income of certain related organizations, for the taxable year.

This Report follows our prior report (the "**Prior Report**") dated June 7, 2018 which discussed certain provisions that affect exempt organizations, including Section 4968.[4]

We generally agree with the approach of the rules set forth in the Proposed Regulations. In this Report, we make recommendations to clarify the rules, identify areas of potential overbreadth, and in some cases, to establish policy grounds for our recommendations.

Part I of this Report lists our principal recommendations. Part II describes Section 4968 generally. Part III provides a detailed discussion of the Proposed Regulations and our recommendations.

I. SUMMARY OF RECOMMENDATIONS

Below are our principal recommendations. Additional technical recommendations are contained in the body of this Report.

A. Applicable Educational Institution

1. We recommend that the final regulations (the "**Final Regulations**") provide additional guidance to clarify that separate but affiliated schools that are under common control (for example, within the same university system) should be aggregated for purposes of determining the number of students for both the 500 student and the $500,000 per student tests. An appropriate standard for determining common control would be to apply the same

[1] The principal drafters of this Report were Stuart L. Rosow and Amy Zelcer, with substantial assistance from Andrew Meiser and Richard R. Upton. Helpful comments were provided by Robert Cassanos, Peter Connors, Stephen Land, Deborah L. Paul, Michael Schler, Dana Trier and Marina Vishnepolskaya. Special thanks to Xiaoyang Ma for her assistance in preparing this Report. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] REG-106877-18, 84 Fed. Reg. 31795 (July 3, 2019) (the "**Preamble**").

[3] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "**Code**") and the Treasury Regulations promulgated thereunder.

[4] New York State Bar Association Tax Report No. 1396, *Report on Provisions of the New Tax Law Affecting Tax-Exempt Organizations* (June 7, 2018) (the **"Prior Report"**).

definition of control already used in Prop. Treas. Reg. Section 53.4968-1(c)(1)(ii).

B. Determining the Number of Students

1. We recommend that a student should be considered as "tuition-paying" regardless of the source of tuition funds, except that an eligible educational institution at which no students pay tuition (i.e. the institution does not charge tuition to any student) will not be considered to have any tuition-paying students.

2. We recommend that each institution be permitted to determine whether a student is "located in the United States" using any reasonable approach, that is consistently applied. Any such approach would have to consider that students who spend substantial time in the United States attending classes be considered located in the United States.

C. Assets Counted for the $500,000 per Student Determination

1. We recommend that the Final Regulations provide that intangible assets in appropriate cases constitute assets used directly in carrying out an institution's exempt purpose, for example, patents or other technology used for teaching or research purposes. To the extent such intangible assets have both exempt and non-exempt uses, institutions should be able to apply the reasonable allocation method enumerated in the Proposed Regulations to determine what portion of the intangible assets would qualify as exempt or non-exempt.

2. We recommend that the IRS and Treasury expand the exclusion from investment assets to take into account certain endowment funds which are set aside for use by the institution for exempt purposes under rules similar to the Section 4942 regulations for set-aside funds.

3. We recommend that the Final Regulations provide that non-financial assets used in what would qualify as a functionally-related business under the principles of Section 4942 and the regulations thereunder (if the applicable educational institution were a private foundation) be considered to be used directly in carrying out an institution's exempt purpose.

D. Determining Net Investment Income and Basis of Property

1. The Final Regulations should explicitly exclude income included in determining an institution's unrelated business taxable income ("**UBTI**") from the computation of net investment income.

2. Unlike private foundations, colleges and universities conduct exempt activities beyond making grants to other charitable institutions and derive income from those activities. Accordingly, we recommend that income and loss from student and faculty loans and student, faculty, and staff housing arrangements be excluded from the computation of gross investment income in the Final Regulations. Items of deduction from these activities would also be excluded in determining net investment income. Further, we reiterate our request for guidance to confirm that activities or assets that generate income that has not traditionally been considered investment income should not be included in gross investment income (for example, tuition, museum or gym admission fees, or income from a related business, such as a campus bookstore).

3. Although we think the result is clear, it would be helpful if the Final Regulations confirm that any capital gain derived from a sale of an exempt-function asset is not taken into account in determining net investment income of an educational institution. While this result is implied by the Proposed Regulations references to Section 4940 and the regulations thereunder, this rule should be made explicit.

4. We recognize that the Proposed Regulations' approach applying a carryover basis to donated property is consistent with the approach taken by Section 4940(c); however, we recommend that any appreciation in a gift of donated property that occurred before the gift to an applicable educational institution was consummated be excluded from the computation of net investment income.

5. Similarly, we recommend that the IRS and Treasury expand the rule treating assets as having a basis equal to their fair market value as of December 31, 2017 for all purposes, including depreciation of such assets, and not just for the computation of gain.

E. Related Organizations

1. We recommend that the Final Regulations provide that any presumption of use or benefit based on prior distributions from a related organization only be made if distributions were made in three of the previous five years, and that the portion of the assets and income presumed to be for the benefit of the institution be based upon an average of the amounts distributed during the five-year look-back period. Any presumption should be able to be rebutted by the institution with facts and circumstances supporting attribution of a lesser amount or by the IRS supporting a larger amount.

2. In the case of organizations that are controlled by an educational institution or that are described in Section 509(a)(3), we encourage Treasury and the

IRS to exempt from the excise tax, assets and income that clearly benefit organizations not subject to the excise tax and that may not be used for the benefit of an applicable educational institution. An example would be a hospital that is controlled by a medical school. In that case, the endowment assets of the hospital should not be subject to the excise tax.

3. We recommend that the Treasury and the IRS clarify the general approach to the application of the excise tax in the context of controlled domestic taxable corporations. We further recommend that any inclusion of the assets and income of a domestic corporation (or partnership) that is controlled (within the meaning of Section 4968(d)) but not wholly-owned by an educational institution be based only on its percentage ownership of the corporation.

F. Income From Foreign Operations and Subsidiaries

1. We recommend that Treasury and the IRS clarify the basic approach to the application of the Section 4968 excise tax in the context of controlled foreign corporations ("**CFCs**") both where an educational institution owns a controlling interest and where an educational institution is a U.S. shareholder but does not own a controlling interest. We further recommend that any inclusion of the assets and income of a CFC or foreign partnership that is controlled (within the meaning of Section 4968(d)) but not wholly-owned by an educational institution be based only on its percentage ownership of the foreign entity. This approach is consistent with the rules applicable to domestic controlled entities.

II. OVERVIEW OF SECTION 4968 AND BACKGROUND

Section 4968 imposes an annual excise tax of 1.4 percent on the net investment income of certain educational institutions.[5] This excise tax is intended to be similar to the excise tax under Section 4940 which applies to private foundations, but not to public charities. As private colleges and universities are generally treated as public charities rather than private foundations, they are not subject to the private foundation excise tax on net investment income under Section 4940.[6] Thus, in response to a recent increase of the endowment balances at many private colleges and universities coupled with a rise in college tuition fees in excess of inflation, Congress imposed this "modest excise tax" on investment income derived from endowments of certain educational institutions.[7] The legislative history justifies the new tax by explaining that in certain cases, the

[5] Legislation to repeal that tax was previously introduced in 2018 by Congressmen John K. Delaney and Bradley Byrne. This legislation was not reintroduced in the current Congress.

[6] STAFF OF S. COMM. ON BUDGET, 115TH CONG., EXPLANATION OF BILL TO THE TAX CUTS AND JOBS ACT, 268 (Nov. 30, 2017), https://www.budget.senate.gov/imo/media/doc/SFC%20Explanation%20of%20the%20Bill.pdf (the "**Senate Report**").

[7] *Id.*

endowments of private colleges or universities had grown so large that it was not commensurate with the scope of the institution's activities in educating students, particularly where a significant portion of the student population does not receive scholarships.[8]

Section 4968 imposes an annual excise tax of 1.4 percent on the net investment income of an "applicable educational institution," as defined in Section 4968(b). The Act defines "applicable educational institution" by reference to Section 25A(f)(2) to include all accredited public, nonprofit, and proprietary (for-profit) postsecondary institutions[9] that have (a) at least 500 tuition-paying students[10] during the preceding taxable year, of which (b) more than 50 percent of the tuition-paying students are located in the United States.[11] The school must be a private school and not a state or community college or university.[12] Finally, the institution must have at least $500,000 in assets per student, "other than those assets which are used directly in carrying out the institution's exempt purpose."[13]

In general, the assets and net investment income of related organizations are attributed to the educational institution,[14] with two exceptions. First, no such amount shall be taken into account with respect to more than one educational institution.[15] Second, unless such related 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 will not be taken into account.[16] A related organization for this purpose is any organization that controls, is controlled by, or is under common control with the private college or

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[8] *Id.*

[9] Section 25A(f)(2) defines "eligible educational institution" as an institution described in the Higher Education Act of 1965 (20 U.S.C. 1088) ("**HEA**") and eligible to participate in certain U.S. federal student financial aid programs. *See also* footnote 25 for further discussion. Treas. Reg. Section 1.25A-2(b).

[10] We understand that the tuition-paying requirement is intended to exempt Berea College (a college in Kentucky that does not charge tuition but has a large endowment) from the tax. Prior Report at 71, FN 107.

[11] For this purpose, the number of students of an institution (and 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(b)(2).

[12] Section 4968(b)(1)(C) provides that an applicable educational institution is not described in the first sentence of Section 511(a)(2)(B), relating to state colleges and universities.

[13] Section 4968(b)(1)(D).

[14] 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* STAFF OF JOINT COMM. ON TAXATION, JCS-1-18, GENERAL EXPLANATION OF PUBLIC LAW NO. 115-97, 290, FN 1357 (2018); Preamble at 31795, FN 1.

[15] Section 4968(d)(1)(A).

[16] Section 4968(d)(1)(B).

university, or that is a supported organization described in Section 509(f)(3) or a supporting organization described in Section 509(a)(3) with respect to the applicable educational institution.[17]

The Conference Report for the Act states that Congress intended that Treasury promulgate regulations to carry out the intended purpose of Section 4968, including regulations that describe: (a) assets that are used directly in carrying out an educational institution's exempt purposes; (b) the computation of net investment income; and (c) assets that are intended or available for the use or benefit of an educational institution.[18]

In June 2018, Treasury and the IRS issued Notice 2018-55[19] to provide interim guidance. Specifically, Notice 2018-55 states that in the case of property held by an institution on December 31, 2017, the institution is generally permitted to use the property's fair market value at the end of 2017 as its basis for purposes of calculating the tax on any resulting gain.[20] The Notice further 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.[21]

The Proposed Regulations define several terms necessary for educational institutions to determine whether the excise tax applies to them, including "applicable educational institution," and several terms related to the number of students that should be counted for purposes of the 500 student test.[22] The Proposed Regulations further clarify what assets count for the $500,000 of assets per student test (including by providing certain rules governing assets of related organizations) and how to value such assets.[23] For affected institutions, the Proposed Regulations clarify how to determine net investment income, including relating to net investment income of related organizations and tax basis.[24] The Proposed Regulations generally incorporate the interim guidance provided in Notice 2018-55.

III. PROPOSED REGULATIONS UNDER SECTION 4968 AND RECOMMENDATIONS

Our substantive recommendations follow, in most cases, after summaries of the relevant provisions of the Proposed Regulations.

A. Applicable Educational Institution

[17] Section 4968(d)(2).

[18] H.R. REP. NO. 115-466, at 555 (2017) (the **"Conference Report"**).

[19] 2018-26 I.R.B. 773.

[20] Notice 2018-55, 2018-26 I.R.B. 773.

[21] *Id.* at 773-74.

[22] Prop. Treas. Reg. Sections 53.4968-1(a)(1) – (3).

[23] Prop. Treas. Reg. Section 53.4968-1(a)(4).

[24] Prop. Treas. Reg. Sections 53.4968-1(b), (c).

Section 4968(b)(1) defines "applicable educational institution," in part, as an eligible educational institution defined in Section 25A(f)(2). Accordingly, the Proposed Regulations provide that an applicable educational institution must be described in Section 25A(f)(2) and the regulations thereunder.[25] The Proposed Regulations further mirror the statute requiring that an applicable educational institution must have at least 500 tuition-paying students attending the institution during the preceding taxable year[26] and that the aggregate fair market value of its assets at the end of such preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purposes) must be at least $500,000 per student attending the institution.[27]

The Proposed Regulations do not address whether multiple affiliated but separately accredited schools that are within the same university system or are otherwise under common control should be aggregated for purposes of the 500 student and $500,000 per student tests. For example, consider a university system in which there are multiple independently organized and accredited schools each with fewer than 500 attending students, but well in excess of 500 students when aggregated within the university system. Similarly, consider a university system which has ten thousand students aggregated among multiple separately incorporated schools, including an undergraduate school with 5,000 enrolled students and multiple other schools with fewer than 500 students each.

The application of the Proposed Regulations to each of these situations is unclear. The Proposed Regulations may be read such that, in the first example, none of the schools would be treated as an applicable educational institution. As nothing in the Proposed Regulations or the statute mandates aggregating related eligible educational institutions for purposes of determining whether an institution is an applicable educational institution, the university system in the first example would arguably not be subject to the excise tax under Section 4968.

In the second example, the undergraduate school with 5,000 enrolled students would be within the definition under Section 4968(b)(1)(A), and under Section 4968(d), the endowments of the other related schools under the same university system would likely be treated as assets and income of the undergraduate school; however, the additional 5,000 students of the other schools within that same university system would not be included for purposes of determining the

[25] Prop. Treas. Reg. Section 53.4968-1(a)(2). Section 25A(f)(2) provides that, for purposes of the allowance of the American Opportunity and Lifetime Learning credits, the term "eligible educational institution" means an institution (1) which is described in section 481 of the HEA, as in effect on the enactment of Section 25A, 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). Section 481 of the HEA does not directly define an "institution," but rather requires the institution meet certain requirements relating to academic years and credit hours to qualify for certain student assistance programs (for example, the federal work-study programs and federal student loans). Treasury Regulations Section 1.25A-2(b)(1)(i) further explains, however, that by referencing Section 481 of the HEA, eligible educational institutions for Section 25A purposes generally include all accredited public, nonprofit and proprietary postsecondary institutions.

[26] Prop. Treas. Reg. Section 53.4968-1(a)(2)(i).

[27] Prop. Treas. Reg. Section 53.4968-1(a)(2)(iv).

$500,000 per student test. The result is that certain institutions with large endowments but many segregated smaller schools, as in the first example, may be unintentionally excluded from the application of Section 4968, and in the reverse, that certain institutions are unintentionally subject to the Section 4968 excise tax because, as in the second example, the institution's assets are aggregated, but then divided by a significantly smaller number of students in calculating the per-student asset value. We believe neither result was intended by Congress, but the better rule would be to aggregate all of the institutions within a single university system.

Recommendation: We recommend that the Final Regulations provide additional guidance to clarify that separate, but affiliated schools that are under common control (for example, within the same university system) should be aggregated for purposes of determining the number of students used in both the 500 student and the $500,000 per student tests. An appropriate standard for determining common control would be to apply the same definition of control used in the Proposed Regulations for purposes of determining related organizations. As illustrated by our second example above, the separate schools within the same university system would be treated as related organizations, and the endowment of each school would likely be aggregated in the calculation of assets and net investment income. Thus, we believe that a consistent definition of control is appropriate and warranted for these purposes.[28]

B. Determining the Number of Students

As described above, the excise tax under Section 4968 is imposed only on educational institutions which have at least 500 tuition-paying students of which more than 50 percent are located in the United States, and at least $500,000 in relevant assets per student.[29] For purposes of making these determinations, "students" include full time equivalent students.[30] Thus, the determination of whether a student is included for purposes of each of these calculations is of utmost importance, and the Proposed Regulations provide guidance on how an institution can define "student," "enrolled," "attending," "tuition-paying," and "located in the United States."

1. "*Student*," "*enrolled*," *and* "*attending*"

The Proposed Regulations define student, in relevant part, as a person enrolled in a degree, certification or other program leading to a recognized educational credential at an institution.[31] Thus, in essence, the Proposed Regulations require that a person be pursuing a recognized academic credential to be considered a student. The Preamble requests comments on whether

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[28] Private universities may be related to or affiliated with public universities, potentially under the same school umbrella. Our comments do not address such situations.

[29] Relevant assets include all assets "other than those assets which are used directly in carrying out the institution's exempt purpose." Section 4968(b)(1)(D).

[30] Section 4968(b)(2).

[31] Prop. Treas. Reg. Section 53.4968-1(a)(3)(i).

further guidance is needed on the definition of "student" as well as on the terms "enrolled" and "attending."[32]

In our Prior Report, we cited examples in which an educational institution might start an online degree or certificate program and enroll enough new students to dilute its per-student investment assets to below $500,000 per student to avoid the Section 4968 tax.[33] Similarly, should post-doctorate programs in which students primarily teach and conduct research or adult education classes be taken into account? Would it be sufficient to meet the "recognized educational credential" requirement if there is a certificate provided at the end of the program?

The requirement of a "recognized educational credential" could encourage manipulation by schools to increase or decrease the number of students pursuant to these rules. At the same time, though, programs may well be offered for the benefit of the community or for other non-tax reasons. For example, a college may allow local residents to enroll in classes without pursuing a degree program or may offer online programs to students all over the world; certain schools may provide executive or certificate programs for students that are interested in learning about recent developments in their field without having to pursue a traditional degree program. It is not clear whether merely offering a certificate at the end qualifies the persons taking these programs as students.

Although we acknowledge the potential for abuse associated with the recognized educational credential requirement under the Proposed Regulations, we believe that Treasury and the IRS should refrain from issuing guidance until ascertaining whether there is actually any abuse by institutions. In support of this "wait and see" approach, any actions by an educational institution to attempt to increase or expand the number of students would likely have non-tax repercussions, including potential dilution of an institution's reputation or imposing a burden on its faculty and facilities. Any such abuse may turn out only to be at the margins and not to affect a material number of institutions, especially in light of the fact that part-time students are taken into account on a full-time student equivalent basis.[34] Moreover, we do not believe that Treasury or the IRS have the expertise to determine, and should necessarily be the arbiter of determining, what counts as a recognized educational credential. We believe that the Final Regulations should not contain an anti-abuse rule or amendment to the recognized educational credential requirement at this time. Treasury and the IRS will have the opportunity to issue a Notice at a later date to the extent specific needs for anti-abuse on this issue arise.

2. *"Tuition-paying"*

Section 4968(b)(1) provides that the determination of an institution subject to tax is made by reference to whether the institution has at least 500 "tuition-paying" students. The Proposed Regulations define "tuition-paying" as the payment of any tuition or fees required for the

[32] Preamble at 31797.

[33] Prior Report at 82.

[34] Section 4968(b)(2).

enrollment or attendance of a student for a course of instruction at an educational institution.[35] Payment for supplies or equipment required during a specific course (for example art or medical supplies) once a student is enrolled in and attending the course or payment for room and board or other personal living expenses are not included for these purposes.[36] Where a student is required to pay a fee to an educational institution that combines charges for tuition with charges for personal expenses such as room and board, that student would be considered a tuition-paying student.[37]

The Proposed Regulations provide disparate treatment of students who receive scholarship funds, depending on the source of such funds. Whether a student is "tuition-paying" is determined without regard to 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.[38] Accordingly, a student will be considered a tuition-paying student if the student receives only a partial scholarship directly from the institution, even if the amount of the scholarship is all but $1 of the required tuition amount. This creates potential for abuse, as institutions may be encouraged to manipulate the structure of scholarship funds in order to increase or decrease the number of "tuition-paying" students pursuant to these rules. For example, as described in the previous sentence, in order to increase the number of "tuition-paying" students and dilute its per-student investment assets to below $500,000 per student, an institution could charge a *de minimis* fee to scholarship recipients or direct the funds to come from an alternate affiliated source, in order to treat those students as "tuition-paying."

As discussed in our Prior Report, based on the limited legislative history, this provision clearly was intended to exempt from the excise tax schools with large endowments that do not charge tuition to any of their students.[39] We previously requested guidance to elucidate how to treat students who receive student aid that is structured in part as a loan, as a tuition waiver in exchange for work, or as a partial scholarship.[40] We believe all of these students should be treated as tuition paying. The distinction made by the Proposed Regulations between scholarship funds provided directly by the educational institution and those that are provided by third parties and potentially administered by the institution creates further problems for making this determination.

Recommendation: In light of the stated intent behind the "tuition-paying" requirement as well as the potentially distortive effect of the Proposed Regulations, we recommend that a student should be considered as "tuition-paying" regardless of the source of tuition funds, except that an eligible educational institution at which no students pay tuition (i.e., the institution does not charge

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[35] Prop. Treas. Reg. Section 53.4968-1(a)(3)(ii)(A).

[36] *Id*.

[37] Prop. Treas. Reg. Section 53.4968-1(a)(3)(ii)(B).

[38] Prop. Treas. Reg. Section 53.4968-1(a)(3)(ii)(C).

[39] Prior Report at 71, FN 107. *See also* footnote 10 (the "tuition-paying" requirement is to exempt Berea College from the tax).

[40] Prior Report at 72.

tuition to any student) will not be considered to have any tuition-paying students. Where an educational institution can direct funds from a variety of sources to be used for scholarship purposes, the source of such funds is effectively fungible. Similarly, an institution that receives the student's labor in lieu of tuition is still receiving a payment. As a result, we do not believe that the Final Regulations should distinguish based on where a student's scholarship funds or other tuition assistance comes from, be it the school itself, an alumni organization directed by the school, or a third-party loan provider. Other than the limited exception suggested above for schools at which no students pay tuition, we see no policy reason for any further exceptions or distinction based on scholarship source.

3. "*Located in the United States*"

Section 4968(b)(1)(B) provides 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, clearly referring to the location of the students, rather than the location of the educational institution or any particular faculty.[41] The Proposed Regulations provide that a student is considered to have been located in the United States if the student is a resident in the United States for at least a portion of the time the student attended the educational institution; however, there is no threshold enumerated.[42]

We acknowledge that each institution may have different policies and practices with respect to orientation programs for study-abroad or other foreign-based curriculum programs, and each may use a different number of days in order to determine for its own internal records whether such a student is considered to be "located in the United States." For example, the Proposed Regulations do not provide guidance with respect to students who are enrolled in study-abroad programs but are located in the United States for a certain short period of time in order to attend registration or orientation programs. Similarly, it is not clear that a student who spends a week in the United States for orientation before attending a branch of the school outside the United States is "located in the United States". Because particular educational programs and their requirements may vary considerably, it is appropriate to provide flexibility to institutions to make the determination based upon their particular facts.

Recommendation: We recommend that each institution be permitted to determine whether a student is "located in the United States" using any reasonable approach. The institution would be required to use such approach consistently in making this determination. The institution's chosen approach would be based upon the particular facts related to the institution's programs. However, the approach would have to consider students who spend substantial time in the United States attending classes as located in the United States.

C. Assets Counted for the $500,000 per Student Determination

[41] Preamble at 31797.

[42] Prop. Treas. Reg. Section 53.4968-1(a)(3)(iii).

In order for an educational institution to be an applicable educational institution subject to the Section 4968 excise tax, the aggregate fair market value of the institution's assets (as well that of certain related organizations) must be at least $500,000 per student attending the institution at the end of the preceding taxable year.[43] The premise of this requirement is that all assets are included, subject to certain exceptions. Assets that are used directly in carrying out an institution's exempt purposes are not included for purposes of calculating the $500,000 per student test.[44] The Proposed Regulations provide that an asset is used directly in carrying out an educational institution's exempt purpose only if it is actually used by the institution in carrying out its exempt purpose, based on all the facts and circumstances.[45] In general, an institution may make a reasonable allocation between exempt and non-exempt uses, provided that if 95 percent or more of total use is for either exempt or non-exempt purposes, then that property will be considered exclusively used for exempt or non-exempt purposes, respectively.[46]

The Preamble refers to Section 4942 and the regulations thereunder as a possible source of guidance for the determination of assets used to carry out an exempt purpose.[47] Section 4942 imposes an excise tax on private foundations that fail to distribute income. Certain determinations under the Section 4942 excise tax exclude assets used to carry out an exempt purpose. However, neither the statute nor the Proposed Regulations specifically mandate the rules under Section 4942 and the regulations thereunder for purposes of determining assets counted for the $500,000 per student test.[48]

1. *Intangible Assets*

Although the Proposed Regulations do not state that only tangible assets are eligible to be treated as "used directly in carrying out an institution's exempt purpose," each of the examples (other than those addressing cash balances) involves tangible property, such as real estate, paintings or artwork, and office equipment and supplies.[49] The statutory language similarly does not limit the types of assets so treated to buildings and other tangible property. The Conference Report provides that assets used directly in carrying out an institution's exempt purpose include "classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets."[50]

[43] Section 4948(b)(1)(D).

[44] *Id.*

[45] Prop. Treas. Reg. Section 53.4968-1(a)(4)(i).

[46] *Id.*

[47] Preamble at 31798.

[48] *See* Preamble at 31798-99; Section 4968; Prop. Treas. Reg. Section 53.4968-1(a)(4)(iv).

[49] *See* illustrations in Prop. Treas. Reg. Section 53.4968-1(a)(4)(ii).

[50] Conference Report at 554, FN 1252.

Our Prior Report requested guidance confirming that various other assets, in addition to physical facilities, be treated as used directly in carrying out an institution's exempt purpose.[51] The examples provided by the Proposed Regulations, while helpful in elucidating whether the cited property is so treated, do not clarify whether intangible assets may also be so treated for these purposes. We believe that intangible assets in appropriate cases should be treated as used directly in carrying out an institution's exempt purpose and that the same principles articulated for other exempt-purpose assets should apply to intangible assets. Educational institutions commonly own intangible assets, such as patents, other technology, or know-how, used for teaching or research purposes. As well, these assets may be separately licensed by those institutions to third parties.

Recommendation: We recommend that the Final Regulations provide that intangible assets in appropriate cases also constitute assets used directly in carrying out an institution's exempt purpose, for example, patents or other technology used for teaching or research purposes. To the extent such intangible assets have both exempt and non-exempt uses, as in the case of a patent used for teaching which is also licensed to a third party, institutions should be able to apply the reasonable allocation method enumerated in the Proposed Regulations to determine what portion of the intangible assets would qualify as exempt or non-exempt.

2. *Funds Set Aside for Use Within a Short Time-Period*

The Proposed Regulations do not provide explicitly that funds set aside for exempt use within a certain time-period may be considered to be used directly in carrying out the institution's exempt purpose, and thus, excluded from the calculation of assets for the $500,000 per student test.[52] The Preamble references Section 4942 at length in its discussion of the asset test under Section 4968, however, and specifically solicits comments on whether the use of the principles of Section 4942 and the regulations thereunder is appropriate here.[53]

The Preamble notes the difference between the statutory language in Section 4968 and Section 4942.[54] Section 4942 excludes assets "which are used (or held for use) directly in carrying out" an exempt purpose.[55] Section 4968 does not contain the parenthetical "or held for use."[56] As such, the Preamble explains that the Proposed Regulations generally follow the regulations under Section 4942 for purposes of determining whether an institution's assets are used directly in carrying out the institution's exempt purpose, but without regard to provisions relating to assets that are "held for use."[57]

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[51] Prior Report at 73.

[52] *See generally*, Preamble at 31798-99; Prop. Treas. Reg. Section 53.4968-1(a)(4).

[53] Preamble at 31798.

[54] *Id.*

[55] Section 4942(e)(1)(A).

[56] Preamble at 31798. *See also* Sections 4942(e)(1)(A) and 4968(b)(1)(D).

[57] Preamble at 31798.

As noted above, Section 4968 does not require application of the Section 4942 rules to determine which assets should be excluded for purposes of the $500,000 per student test. This is in contrast to the explicit statutory reference to Section 4940(c) in the Section 4968 rules for purposes of calculating net investment income. Thus, the comparison to Section 4942 is merely implicit based on substantive similarity between the two excise tax regimes.[58] That said, some differences in the regulations under Section 4942 as compared with Section 4968 should be considered.

In particular, our Prior Report noted that certain endowment funds held and used directly in carrying out a school's educational purposes seemingly could qualify as assets used directly in carrying out the school's exempt purposes.[59] We suggested that such assets would include funds set aside for use by the institution for exempt purposes (such as to build a new library or classroom) within a relatively short period of time.[60]

Our Prior Report set forth three examples. The first example described a donor who sets up a scholarship fund, restricting its use to providing scholarships for first generation students. We recommended that the funds should not be considered investment assets for the test and that the scholarships granted should be considered related expenses.[61] The second example described a school with a capital campaign to build a new science laboratory, for which any funds raised would be spent within three years. In our example, the school transferred $100 million from its endowment to this laboratory fund. We recommended that the funds raised in the campaign should not be considered investment assets, but that the amount transferred from the endowment (since the restriction is self-imposed) should still be considered investment assets until actually spent.[62] The third example involved a school that borrows money to build a new football stadium. We concluded that while the funds are held temporarily, but earmarked for that specific purposes, and there is an offsetting loan, there should be no addition to assets.[63]

Further, as in our Prior Report, we note that the exclusion of assets from the determination of whether the institution has investment assets of $500,000 per student is solely for the purpose of determining eligibility for the excise tax. Thus, any potential exclusion is likely to affect only a few institutions that are close to being subject to the tax. In addition, even if the assets were excluded for purposes of the $500,000 per student test, the investment income generated by such assets would remain subject to the excise tax if the institution meets the criteria for being subject to the excise tax.

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[58] *See Id*.

[59] Prior Report at 73.

[60] *Id.* at 73-74.

[61] *Id.* at 74.

[62] *Id.*

[63] *Id.*

The Proposed Regulations do in fact permit certain assets that are held for use to be excluded from the $500,000 per student test.[64] An example in the Proposed Regulations provides that reasonable cash balances necessary to cover current administrative expenses and other normal disbursements directly connected with the institution's exempt activities would be permitted to be excluded from the $500,000 per student investment asset test, provided the institution's actual cash balances do not exceed a certain threshold.[65] By contrast, another example in the Proposed Regulations provides that assets held for the production of income or investment, regardless of future exempt use of such funds, are not excludable.[66] While technically, endowment funds set aside for exempt use would more likely fall within the scope of the latter example, the existence of the cash balance example demonstrates that there are limited circumstances in which funds, which otherwise would be considered investment assets, can and should be excluded in light of particular policy circumstances.

Further, it is not clear that the absence of the phrase "held for use directly" in Section 4968(b)(1)(D) justifies automatic inclusion of assets that are "held for use" in the asset test. The drafters could have included the "or held for use directly" phrase from Section 4942 if they intended; however, there is no evidence that the drafters copied language from Section 4942 and specifically intended to exclude this phrase. Moreover, the legislative history of Sections 4942 and 4968 suggests no policy reason for a different treatment of assets "held for use" under the two sections. Section 4942 was enacted to address the concern that private foundations could indefinitely hold (and therefore not deploy for charitable purposes) assets that did not produce income, even though the donor got the benefit of a current tax deduction.[67] Similarly, the goal of enacting Section 4968 was to tax sizeable endowments of colleges and universities that are not currently being expended for a charitable or educational purpose.[68] Since both provisions aim to prevent long-term accumulation of assets, the legislative history does not appear to support distinguishing between currently used and earmarked funds for purposes of Section 4968. Hence, funds earmarked for an educational purpose should be excluded from the asset test.

The Section 4942 regulations further support the exclusion of assets earmarked for educational purposes by providing that an asset is used (or held for use) directly in carrying out a foundation's exempt purpose only if the asset is actually used by the foundation in the carrying out of the charitable, educational, or other similar purpose which gives rise to the exempt status of the foundation, or if the foundation owns the asset and establishes to the satisfaction of the Commissioner that its immediate use for such exempt purpose is not practical (based on the facts and circumstance of the particular case) and that definite plans exist to commence such use within

[64] Prop. Treas. Reg. Section 53.4968-1(a)(4)(ii).

[65] Prop. Treas. Reg. Section 53.4968-1(a)(4)(ii)(D).

[66] Prop. Treas. Reg. Section 53.4968-1(a)(4)(iii)(A).

[67] Under prior law, a private foundation lost its exemption if its aggregate accumulated income was "unreasonable in amount or duration." Therefore, the private foundation had no obligation to make distributions for charitable purposes if its assets produced no income. S. REP. NO. 91-552, 1969-3 CB 423, 446-47 (1969).

[68] Senate Report at 268.

a reasonable period of time.[69] The regulation then distinguishes assets used or held for use directly in carrying out an exempt purpose on the one hand with assets held for the production of income or for investment, on the other hand.[70]

We recognize that a rule that excludes funds that are set aside for projects gives institutions leeway to manipulate the asset computation. Universities could set aside money for the requisite period of time for routine salaries, routine maintenance of campus buildings or scholarships perhaps. Such a rule could also encourage universities to set aside endowment funds for exempt purposes, which purposes were previously funded by current giving, or to request changes in the designations of pledges from donors in order to come within the rule that permits the exclusion of set-aside funds from the asset test. However, given that the exclusion discussed here is only for purposes of the asset test to determine eligibility for Section 4968 and does not exempt income from set-aside funds from the actual excise tax, we question the likelihood of abuse in this context.

In balancing the potential for abuse with the recognition that some projects are long term and require acquisition of funds over time, we believe it would be appropriate to limit the exclusion only to funds that are set aside specifically for the purpose of acquiring or creating an asset that would (if already purchased or completed) itself be excluded from the $500,000 asset per student test because such asset is used directly in carrying out the institution’s exempt purpose. Funds set aside for payment of salaries or other operational costs should not qualify for this “set aside” exclusion.

Further, we believe that such funds should be required to be spent within a limited time. For this purpose, we believe set-aside funds should be excluded based on rules similar to those under the Section 4942 regulations. These regulations permit amounts set aside for a specific exempt-function project to be excluded from the excise tax to the extent a private foundation establishes to the satisfaction of the IRS that the amount set aside will be paid for that project within 60 months after it is set aside and the set-aside satisfies both a suitability test and a cash distribution test.[71] The suitability test requires advance approval from the IRS. These tests applied in the Section 4968 context would ensure that an educational institution’s use of endowment funds is warranted for the specific exempt purpose within the extended period of time permitted by the rules.[72] Such a rule would permit the IRS to control any potential abuse as approval would generally be subject to an IRS ruling or other approval process set forth in regulations. Based on the relatively small numbers of educational institutions that are on the cusp of constituting applicable educational institutions, and the fact that these set-aside issues pertain only to qualification, and not to the actual tax amount, we would expect that the influx of ruling requests would not pose an administrative burden to the IRS.

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[69] Treas. Reg. Section 53.4942(a)-2(c)(3)(i).

[70] *Id.*

[71] Section 53.4942(a)-3(b).

[72] We do not believe that Treasury and the IRS should be bound to use a 60 month period, but could consider a shorter period of time.

Recommendation: We recommend that the IRS and Treasury expand the exclusion from investment assets to take into account certain endowment funds which are set aside for use by the institution for exempt purposes, under rules similar to those under the Section 4942 regulations for set-aside funds. This type of exclusion would be less vulnerable to abuse by educational institutions, as compared with an exclusion of named scholarship funds. The latter could incentivize donors to place restrictions on their gifts or incentivize institutions to request that donors place restrictions on their gifts. The exclusion we recommend would enable the IRS to carefully evaluate set-asides through IRS approval procedures. Further, our recommended exclusion would only be for funds that are set-aside to create or acquire assets that would themselves be excludable from the $500,000 per student tests once acquired.

3. *Functionally-Related Businesses*

The Proposed Regulations do not address whether a functionally-related business would be considered an exempt use asset for purposes of excluding it from the $500,000 per student test.[73] Functionally-related businesses are an illustration of an exempt use asset in the regulations under Section 4942.[74] The Preamble, however, questions whether the concept of a functionally-related business would apply to an educational institution.[75]

Any university-affiliated activity that generates revenue that may be related to the university's educational purposes would constitute a functionally-related business. University theatres which produce plays, student newspapers with circulation or ad sales, or similar activities that operate as businesses while buttressing the educational mission of an educational institution are relevant examples. Assets used in these businesses include not just physical assets, such as buildings or equipment, but also intangible assets, such as copyrights, licenses and goodwill. Working capital or other financial resources relating to such functionally-related businesses should, however, be treated in the same manner as other financial assets of the institution and included both in measuring the $500,000 test and in computing net investment income.

Recommendation: We recommend that the Final Regulations provide that non-financial assets used in what would qualify as a functionally-related business under the principles of Section 4942 and the regulations thereunder (if the applicable educational institution were a private foundation), be considered to be used directly in carrying out an institution's exempt purpose.

[73] Preamble at 31798-99.

[74] Treas. Reg. Sections 53.4942(a)-2(c)(3)(ii)(d), (iii); *see also* Section 4942(j)(4), which defines functionally-related business as a trade or business other than "an unrelated trade or business (as defined in Section 513), or an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization."

[75] Preamble at 31799.

D. Determining Net Investment Income and Basis of Property

Section 4968(c) states that net investment income is determined under rules "similar to" the rules of Section 4940(c). The Proposed Regulations provide that an institution must calculate its net investment income under the rules of Section 4940(c) and Treas. Reg. Section 53.4940-1(c) through (f), with certain modifications.[76] Section 4940 provides that net investment income is calculated based on the sum of gross investment income and capital gain net income, minus permitted deductions.[77] Under these rules, gross investment income includes all income from interest, dividends, rents and royalties from all sources, other than UBTI.[78]

1. *UBTI*

The Proposed Regulations exclude from net investment income any income that is included in determining the institution's UBTI through cross-references to the rules under Section 4940.[79] Section 4940(c) and Treas. Reg. Section 53.4940-1(d) provide that UBTI taxed under Section 511 is excluded for purposes of determining net investment income,

Recommendation: The Final Regulations should explicitly exclude income included in determining an institution's UBTI from the computation of net investment income, rather than through a mere cross-reference to Section 4940.

2. *Distinguishing Section 4968(c) from Section 4940(c): Exempt Function Activities, Student Loan Interest, and Student Housing Rents*

The Proposed Regulations solicit comments regarding the proper treatment of certain investment-type income derived from exempt-function activities, which income would be net investment income and subject to the excise tax, based purely on a strict adoption of Section 4940(c) and the regulations thereunder.[80]

As we discussed in our Prior Report, the Section 4940 regulations make clear that interest, dividends, rents, and royalties (other than UBTI) from assets devoted to charitable activities are includible in gross investment income.[81] UBTI is excluded under the rationale that the income is already subject to U.S. federal income tax.[82] Accordingly, even though assets used in carrying out an institution's exempt purpose may be excluded in determining whether a school has met the

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[76] Prop. Treas. Reg. Section 53.4968-1(b)(2).

[77] Section 4940(c)(1).

[78] Treas. Reg. Section 53.4940-1(d).

[79] Prop. Treas. Reg. Section 53.4968-1(b)(2).

[80] *See generally* Treas. Reg. Sections 53.4940-1(c) through (f). *See also* Preamble at 31800.

[81] Prior Report at 80.

[82] S. REP. NO. 91-552, 1969-3 CB 423, 441-42 (1969).

$500,000 per student asset threshold, investment-type income from such assets is seemingly included in the determination of net investment income.[83]

In most cases, exempt-function income of a nonprofit organization or educational institution would be active income that would not be considered investment-type income and thus would not be captured by the Section 4968 excise tax. However, in the case of educational institutions, certain types of investment-type income are related to the institution's exempt purpose. Neither the statute nor the Proposed Regulations explicitly excludes such exempt-function investment income.[84] Examples include student or faculty loan interest, and rents from student, faculty or staff housing.[85] The Section 4940 regulations specifically state that "interest received on a student loan would be includible" in gross investment income.[86]

Our Prior Report noted certain issues raised by the inclusion of such items in gross investment income.[87] We explained that Section 4940(c)(3), in determining net investment income, allows as a deduction all 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.[88] Where assets such as dormitories or faculty housing run at a tax loss (possibly as a result of subsidies given by the institution or the institution not charging fair market rent), such loss reduces net investment income.[89]

Notably, Section 4968(c) provides that net investment income is determined under rules "similar to" (but not identical to) the rules of Section 4940(c).[90] Thus, an exact following of Section 4940(c) and the regulations thereunder is not mandated by Section 4968.[91] Unlike private foundations, colleges and universities exist to serve a specific educational purpose. Such institutions charge tuition and provide for the education of their students as part of their primary exempt activities. As discussed in the Preamble, certain types of income that would be included in net investment income of a private foundation should not necessarily be included in the case of

[83] Prior Report at 80.

[84] Treasury Regulation Section 53.4940-1(d)(1) provides that gross investment income includes interest, dividends, rents and royalties income received by a private foundations "from all sources" except to the extent such income is included in computing the tax imposed on UBTI. The Proposed Regulations adopt such rule. Prop. Treas. Reg. Section 53.4968-1(b)(2).

[85] Prior Report at 80.

[86] Treas. Reg. Section 53.4940-1(d)(1).

[87] Prior Report at 80.

[88] *Id.*

[89] *Id.*

[90] Section 4968(c).

[91] *See* Preamble at 31800.

an educational institution, especially when such income is derived in a manner that is inextricably linked with the educational and exempt purposes of the institution.[92]

A significant type of income unique to educational institutions would be student loan interest. The Preamble acknowledges that student loans provided by an applicable educational institution to its students can be viewed as a form of deferred tuition which will be paid when the student graduates from the institution and enters the workforce.[93] As such, the Preamble generally considers any interest on a student loan to be distinguishable from other investment income in cases where the interest rate is a below-market rate. In such a case, the Preamble reasons that a student loan is more akin to a scholarship from the school to a student than an actual loan intended to generate income and thus the interest income on the loan should not be included in gross investment income.[94] We support that reasoning.

We also believe that the determination of whether a student loan is at a market rate or below a market rate is unduly burdensome on the institution and should not be the test. Student loans cover a variety of situations—from those of low income students for whom no credit might be available at all to students from middle income families who could seek third party financing. Determining the market in these different situations would be exceedingly difficult. Such a determination may be made even more difficult by government support of student lending, which could influence the rate charged on certain types of student loans.

We believe the better approach is to exempt interest on all student loans. Unlike investment activities, the principal purpose of making such loans is not to generate income, but to enable students to attend the school. As long as that is the principal purpose of the program, we believe interest should be excluded. While there may be situations in which the loan program is actually used as an alternative to other investments, as described below with respect to loans to faculty, we believe that those instances will be rare and can be addressed either in future guidance or on a case specific basis.

We would also extend this reasoning to faculty loans, which in many circumstances are provided in order to give an educational institution a competitive edge in attracting talented educational professionals. The straightforward circumstance, similar to that of student loans, is one in which an educational institution provides below-market interest rates on loans to faculty members. As discussed above, in this scenario, the educational institution is offering a benefit to professors and other faculty members in order to attract talented professionals to the institution, a pursuit that should be viewed as related to the educational purposes of the institution.[95] More generally, for schools located in areas with high real estate living costs, institutional support for housing is a necessity to attract high quality faculty and researchers. In other cases, loans are

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] *See Id.* (stating that student loans are provided to help the educational institutions to fulfill their missions of educating students).

provided to faculty and staff who would otherwise not be able to obtain bank financing. We believe that in general such loans are provided for educational, rather than investment purposes. Accordingly, we believe that such interest income should also be excluded. Additionally, we note that this type of financing is an alternative to providing housing directly, the income or loss from which, as noted below, should also be excluded. As both activities serve an exempt function of the institution, we recommend that the income or loss not be included in determining net investment income.

There are of course nuances with respect to the types of faculty loans that may be provided by an educational institution, and as such, we acknowledge that such nuances may warrant disparate treatment depending on the facts. In particular, loan programs that are effectively substitute for bank financing, such as loans to high income faculty at professional schools, may warrant a different treatment. In such a case, we believe that an examination of all of the facts and circumstances would be relevant in determining whether the principal purpose of the program is to further the educational mission by attracting and retaining faculty or whether such a program is really an investment vehicle. Among the facts that would be relevant are the resources of the borrowers, interest rate charged, availability of credit in the local area and scope and extent of the program. A program, for example, that extended loans primarily to high income faculty to acquire luxury home at rates similar to those charged by banks would seem to be an investment vehicle rather than a program used to support educational goals.

Income and loss from student and faculty housing arrangements is another area which can be distinguished from other rental income that would be included in net investment income under Section 4940. In discussing this particular issue in our Prior Report, we set forth several possible approaches and reasoned that the best answer was probably to exclude both the income and expenses from the use of exempt assets or activities.[96] The Preamble recognizes 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), faculty, and other staff.[97] We note that in many cases the housing that schools offer to their students and faculty operate at a loss. Further, student, faculty, and staff housing in particular is not only a source of income (if any) for schools and a convenience for such individuals. The opportunities for education on a university campus are not confined to the classroom, and a vital component of the educational experience, both academically and socially, for students of colleges and universities no doubt takes place as a result of student housing. Similarly, in many cases, faculty and staff housing enables a university to attract educators who would not otherwise be able to afford or find suitable housing near a university campus; the ability to attract top educational professionals for professorships and other teaching positions is inextricable from the educational purpose of an institution. As such, student, faculty, and staff housing can be distinguished from general rental income received by an institution or a private foundation and should be excluded from the computation of investment income.

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[96] *See* Prior Report at 81.

[97] Preamble at 31800.

Further, there should be no requirement that such student, faculty or staff housing be offered at below-market rents. Regardless of cost, such housing fulfills an educational purpose, enabling students, faculty and staff to live on or near campus. Any special requirement to exclude such rental income based on below-market rates would require educational institutions to obtain appraisals to value any housing facilities that many such institutions have owned for many years, a process that would be cumbersome and costly, not to mention subject to other potential abuses and challenges. As such, in the case of student, faculty, and staff housing, an exemption from net investment income should be instituted.

Recommendation: In general, the unique nature and function of educational institutions provide a basis to distinguish Section 4968 from Section 4940 and the regulations thereunder. Unlike private foundations, colleges and universities exist to serve a specific educational purpose, and we recommend that income and loss from student and faculty loans and student, faculty, and staff housing arrangements be excluded from the computation of gross investment income in the Final Regulations. Further, we reiterate our request for guidance to confirm that activities or assets that generate income that has not traditionally been considered investment income should not be included in gross investment income (for example, tuition, museum or gym admission fees, or income from a related business, such as a campus bookstore).[98]

3. *Investment Income Derived From Assets Used for Exempt Purposes and Capital Gains or Losses on Dispositions of Such Assets*

As discussed above, the Proposed Regulations adopt the approach of Section 4940(c) and the regulations thereunder for purposes of calculating net investment income of an applicable educational institution.[99] Section 4940 provides that net investment income is calculated based on the sum of gross investment income and capital gain net income, minus permitted deductions.[100] In general, capital gain net income (and thus net investment income) includes capital gain derived from a sale of property held for investment purposes.[101] However, capital gain derived from a sale of property held or used for exempt function purposes is excluded.[102]

Although we think the result is clear, it would be helpful if the Final Regulations confirm that any capital gain derived from a sale of an exempt-function asset is not taken into account in determining net investment income of an educational institution. While this result is implied by the Proposed Regulations references to Section 4940 and the regulations thereunder, this rule should be made explicit.

4. *Gifted Property*

[98] Prior Report at 81.

[99] Prop. Treas. Reg. Section 53.4968-1(b)(2).

[100] Section 4940(c)(1).

[101] Section 4940(c)(4); Treas. Reg. Section 53.4940-1(f)(1).

[102] Treas. Reg. Section 53.4940-1(f)(1).

For purposes of calculating net investment income, capital gain derived from a sale of investment assets is taken into account, including to the extent such assets were donated to the educational institution.[103] Under the Proposed Regulations, an applicable educational institution computes gain on the sale or disposition of donated property using the donor's basis.[104] The Proposed Regulations generally follow the rules for determining gain upon the sale or other disposition of property under Section 4940(c).[105] 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[106], including the rule providing that the basis of property acquired by gift is generally the same as the donor's basis.[107]

Thus, under the Proposed Regulations, any appreciation of donated property that occurs while the property is owned by the donor must be taken into account by a recipient educational institution when the property is disposed of, despite the fact that such appreciation arose in the donor's hands, and thus is not economic income of the institution. Donors receive the benefit of fair market value basis step-up for purposes of their charitable deductions in most cases. The approach of the Proposed Regulations shifts the tax burden of appreciation that occurs prior to the date of donation onto educational institutions, disregarding economic realities.

Ordinarily, in contributions to public charities, pre-donation appreciation is not taxed, as neither the donor nor the recipient is required to pay tax on the gain. It is unclear why the result should be different for educational institutions. We recognize that Section 4968 is intended to use rules similar to those under Section 4940 in determining net investment income, and on that view, the donor's basis as set forth in Treas. Reg. Section 53.4940-1(f)(2) for purposes of computing a private foundation's net investment income may be seen to apply for purposes of Section 4968. Nevertheless, given the treatment of public charities generally, we do not believe that subjecting appreciation of gifted property to the excise tax is a reasonable extension of the private foundation rules.[108] Further, the rules governing gifts to private foundations are necessarily focused on potential abuses related to insiders and control by individuals over foundations. These concerns are not the same in the context of educational institutions.

In addition, the existence of a carryover basis rule with respect to educational institutions but not with respect to other public charities or donor advised funds creates potential loopholes. Educational institutions would likely encourage donors to donate any built-in gain property to

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[103] Prop. Treas. Reg. Section 53.4968-1(b)(2); Treas. Reg. Section 53.4940-1(f)(2)(i).

[104] Prop. Treas. Reg. Section 53.4968-1(b)(2); Section 4940(c)(1); Section 1015(a). *See also* Preamble at 31800. However, as discussed in Part III.D.5, for purposes of determining gain on disposition of property held on December 31, 2017, under the Proposed Regulations, basis would be the fair market value as of such date, if greater.

[105] Prop. Treas. Reg. Section 53.4968-1(b)(2).

[106] Sections 1 through 1563 of the Code.

[107] Section 1015(a); Treas. Reg. Section 1.1015-1(a).

[108] We further question whether such rule under Section 4940 is the correct answer as a policy matter. In addition, we note that when contributing qualified appreciated stock to a private foundation, a donor may (subject to certain limitations) deduct the full amount of the stock's fair market value at the time of the contribution. Section 170(e)(5).

donor advised funds, which could sell the property and then contribute the cash proceeds to the institution. Thus, the carryover basis rule for purposes of gifts to educational institutions could be easily avoided.

Recommendation: We recommend that any appreciation in a gift of donated property that occurred before the gift to an applicable educational institution was consummated be excluded from the computation of net investment income.

5. *Basis as of December 31, 2017*

As in Section 4940(c), general income tax principles apply for purposes of calculating net investment income under Section 4968, including for determining the basis of any assets.[109] However, for purposes of determining gain on a disposition of an asset held by an educational institution on December 31, 2017, the basis of such asset is the greater of (i) its fair market value as of December 31, 2017, or (ii) its basis determined under general federal income tax principles.[110]

By adopting the regulations under Section 4940(c), the Proposed Regulations effectively provide that the basis of any assets held by an educational institution for purposes of determining loss on a disposition of such asset, as well as for depreciation or depletion purposes, is determined under general federal income tax principles.[111] Thus, for depreciation or depletion purposes, depreciation is computed using the institution's historic basis without any increase for the asset's value on December 31, 2017.[112]

Educational institutions may be motivated to engage in "self-help" by selling assets they own and purchasing similar use assets in order to obtain depreciation deductions based on a fair market value basis. Similar economic effects could also be achieved through sale and leaseback transactions. As a result, institutions may effectively be able to obtain the same benefits in respect of depreciation deductions that the basis step-up would have afforded them if it had applied for depreciation purposes.

In addition, we believe that this issue is more significant for educational institutions that will almost certainly hold depreciable assets than it is for private foundations that may, but are not likely to, hold a material amount of depreciable assets. As such, the failure to adjust basis for depreciation purposes has a far more distortive effect for educational institutions than it did for private foundations. Accordingly, we believe that the Final Regulations should extend the benefits of the basis step-up for purposes of computing depreciation and depletion.

Recommendation: We recognize that the Proposed Regulations' approach applying the December 31, 2017 value only for purposes of calculating gain upon disposition of such assets is

[109] *Id.*; Section 4940(c)(1).

[110] Prop. Treas. Reg. Sections 53.4968-1(b)(2), (3); Treas. Reg. Section 53.4940-1(f)(2)(i).

[111] Prop. Treas. Reg. Section 53.4968-1(b)(2); Treas. Reg. Sections 53.4940-1(e)(2)(iii), (f)(2)(ii).

[112] Prop. Treas. Reg. Section 53.4968-1(b)(2); Treas. Reg. Section 53.4940-1(e)(2).

consistent with the approach taken in the regulations under Section 4940. However, we recommend that the IRS and Treasury expand the scope of the basis step-up for property held on December 31, 2017 so that it also applies for purposes of depreciation and depletion.

E. Related Organizations

Section 4968(d) generally treats assets and net investment income of any related organization of an applicable educational institution as assets and net investment income of the educational institution itself.[113] As a result, the excise tax is imposed on the net investment income of certain related organizations, both exempt and taxable, as well as on the net investment income of the educational institution.[114] No amounts are taken into account with respect to more than one educational institution, however.[115] Further, assets and net investment income "not intended or available for the use or benefit of the educational institution" are not taken into account (except in the case of any organizations controlled by the educational institution, or supporting organizations of the institution described in Section 509(a)(3)).[116]

For purposes of these rules, a related organization is any organization that controls, or is controlled by, the educational institution, is under common control with the institution, or that is a supported organization described in Section 509(f)(3) or a supporting organization described in Section 509(a)(3) with respect to the educational institution.[117]

The Proposed Regulations provide that the definition of "control" for purposes of Section 4968 is based on the rules provided by Section 512(b)(13)(D) and the regulations thereunder.[118]

1. *Definition of* "*Control*"

The Proposed Regulations provide that "control" is a 50 percent threshold, and generally aligns with the definition of related organization under Section 512(b)(13)(D)[119] and with the annual reporting requirements on Form 990.[120] The Preamble notes that these rules are intended

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[113] 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* STAFF OF JOINT COMM. ON TAXATION, JCS-1-18, GENERAL EXPLANATION OF PUBLIC LAW NO. 115-97, 290, FN 1357 (2018); Preamble at 31795, FN 1.

[114] *See* Section 4940(d)(1).

[115] Section 4968(d)(1)(A).

[116] Section 4968(d)(1)(B). The Proposed Regulations provide special rules to the effect that an applicable educational institution with a Type III related organization may take into account only the assets and the net investment income of the related Type III organization that are intended or available for the use and benefit of such applicable educational institution. Prop. Treas. Reg. Section 1.4968-1(c)(3)(ii).

[117] Section 4968(d)(2).

[118] Preamble at 31801.

[119] This includes the constructive ownership rules of Section 318.

[120] Preamble at 31801. *See also* Prop. Treas. Reg. Section 53.4968-1(c)(1)(ii).

to be consistent with the position taken in Notice 2019-09,[121] which provides interim guidance to private foundations under Section 4960 in determining related organizations.[122] The Preamble and Notice 2019-09 reason that consistency among exempt organizations rules and reporting requirements reduces compliance burdens and that the 50 percent threshold mitigates the potential for abuse that could arise under a higher 80 percent control threshold.[123]

In our Prior Report, we recommended an 80 percent threshold for control for purposes of Section 4960 and 4968.[124] We now believe that the 50 percent threshold as set forth in Section 512(b)(13)(D) is appropriate. The benefit of consistency with other exempt organization control tests, including the recent guidance issued under Section 4940, outweighs the fact that more income of related parties would be subject to the tax. In addition, as set forth below, we believe that this adverse impact can be limited by adopting rules intended to ensure that only income and assets that are actually available to the educational institution are included in determining the amount of tax payable.

2. *Allocation Among Educational Institutions*

The Proposed Regulations address the rule in Section 4968(d)(1)(A) that the assets and net investment income of a related organization are taken into account only with respect to one applicable educational institution.[125] Where an organization is a related organization with respect to more than one applicable educational institution, the assets and net investment income of the related organization must be allocated among the educational institutions being supported by the related organization.[126] Under the Proposed Regulations, this can be done in any reasonable manner taking into account all facts and circumstances, and must be consistently applied across all related organizations.[127]

This approach is consistent with our recommendation in our Prior Report.[128] We illustrated the reasonableness and consistency rule by describing an educational institution which would be permitted to use its share of the assets of a controlled entity or organization or the value of the educational institution's interest in the controlled entity or organization as the value of the assets owned by the educational institution.[129] We adhere to our view that any reasonable methodology that takes into account all facts and circumstances and is applied consistently across all related

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[121] 2019-04 I.R.B. 403.

[122] Preamble at 31801.

[123] *Id.*; Notice 2019-09, 2019-04 I.R.B. at 406.

[124] Prior Report at 76 and 69.

[125] Preamble at 31802-03; Prop. Treas. Reg. Section 53.4968-1(c)(2)(ii)(A).

[126] Prop. Treas. Reg. Section 53.4968-1(c)(2)(ii)(A).

[127] *Id.*

[128] Prior Report at 76.

[129] *Id.* at 77.

organizations is appropriate for purposes of avoiding double-counting of related organization assets and income.

3. "*Intended or Available for the Use or Benefit*" *of the Educational Institution*

As discussed above, Section 4968(d)(1)(B) provides that the assets and net investment income of a related organization be considered as assets and income of the applicable educational institution, other than assets and net investment income which are not "intended or available for the use or benefit of" the educational institution.[130] The Proposed Regulations provide that when a related organization controls or is under common control with the educational institution (other than Type I and II supporting organizations described in Section 509(a)(3) of an institution), the assets and net investment income of the related organization must be allocated between those intended or available for the use and benefit of the educational institution and those not intended or not available for the use and benefit of that educational institution.[131] 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.[132]

The Proposed Regulations explain that assets and net investment income of a related organization are "intended or available for the use and benefit of" an 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.[133] 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 otherwise not fairly attributable to the educational institution.[134]

This rule is consistent with the legislative history. The Conference Report provides that a related organization's assets "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… would be disregarded."[135]

Our Prior Report highlighted the importance of ensuring that assets and income of a related organization only be treated as assets and income of the educational institution to the extent of relatedness.[136] We provided an example in which an educational institution owned and controlled

[130] Section 4968(d)(1)(B). Note that this rule is not applicable to supporting organizations as described in Section 509(a)(3) with respect to an educational institution.

[131] Prop. Treas. Reg. Section 53.4968-1(c)(2)(ii)(B)(2).

[132] *Id.*

[133] *Id.*

[134] *Id.*

[135] Conference Report at 555.

[136] Prior Report at 76.

only 80 percent of a related organization, and maintained that in such a case, only 80 percent of the organization's assets and income should be treated as that of the educational institution, unless 100 percent of those funds were intended or available for the use or benefit of the institution. [137] The Proposed Regulations follow our recommendation that an educational institution be permitted to take into account its own unique facts and circumstances and use any reasonable method to value its interest in related organizations.[138]

The Proposed Regulations provide two examples of methods that would per se be considered reasonable for this purpose in the context of a Type III supporting organization.[139] A method treating all distributions received from a related organization as net investment income of the school each year is deemed reasonable.[140] Another reasonable method would allocate a related organization's net income and assets based upon the percentage of the related organization's total distributions that are made to the educational institution.[141]

The Preamble inquires about other methodologies where specific earmarking is not present, including whether a presumption should be established based on total distributions in one year from a related organization to an institution, absent demonstrated facts and circumstances to the contrary.[142] While the notion of a presumption based on distributions generally seems reasonable, one based solely on the prior year's distributions would seem potentially inaccurate, subject to manipulation, and in certain cases, unduly punitive of educational institutions where one single year of extraordinary distributions could affect that institution going forward. A better approach would be a presumption where there is a pattern of distributions to the educational institution over a number of years. In that case, the presumption, while rebuttable, could be based upon an average of those distribution.

Recommendation: We agree with the approach taken in the Proposed Regulations to permit allocation of related organization assets and income between educational institutions in a reasonable manner, consistently applied across all related organizations. With respect to the inquiry posed in the Preamble regarding other methodologies where there is no specific earmarking or designation of funds, we agree that a presumption based on prior distributions seems reasonable. We recommend that any presumption of use or benefit based on prior distributions from a related organization only be made if distributions were made in three of the previous five years. Then, if the institution meets the requirements for a presumption to be made, the appropriate amount to be used for future year presumed distributions should be an average of the amounts distributed during the five-year look-back period. We also recommend that the Final Regulations specify that any

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[137] *Id.*

[138] Prop. Treas. Reg. Section 53.4968-1(c)(2)(ii)(B)(2).

[139] Prop. Treas. Reg. Section 53.4968-1(c)(2)(ii)(B)(3)(ii); Section 509(a)(3)(B)(iii).

[140] Prop. Treas. Reg. Section 53.4968-1(c)(2)(ii)(B)(3)(ii).

[141] *Id.*

[142] Preamble at 31802.

presumption can be rebutted by the institution with facts and circumstances supporting attribution of a lesser amount or by the IRS supporting a larger amount.

4. *Supporting Organizations Described in Section 509(a)(3)*

Section 4968(d)(1)(B) and the Proposed Regulations provide that to the extent an organization is controlled by an educational institution or is a certain type of supporting organization with respect to such institution, the assets and net investment income of such organization are treated 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 or not.[143] In these cases, the rules permitting allocation based on use or intended benefit of such assets or funds will not apply, even if such assets and income are specifically earmarked or restricted for a different entity or are not fairly attributable to the educational institution.[144]

We recognize that this rule appears in the statute. However, we also wish to highlight the unintended and odd consequences that stem from the application of this rule depending on the particular quirks of an institution's organizational structure.

Examples include scenarios in which a supporting organization controls both an applicable educational institution and a hospital or a secondary school (both of which are organizations that would be independently tax-exempt). In such a structure, regardless of whether endowments are commonly or separately managed, and regardless of whether funds specifically benefit or are earmarked for the hospital or secondary school (and not the educational institution within the group), all assets and net investment income would be treated as assets and net investment income of the applicable educational institution. The result is that Section 4968 could impose tax on assets and net investment income of other tax-exempt organizations, despite the fact that the intended targets of Section 4968 are eligible educational institutions.

Recommendation: The rule that precludes allocation of assets or net investment income based on use or intended benefit in the case of a related organization that is controlled by an educational institution or that is described in Section 509(a)(3) may produce unintended and odd results in certain organizational structures. We recognize that it may be difficult to avoid this result under the language of the statute. Nevertheless, we believe that subjecting assets and income belonging to and benefiting organizations that are not the target of Section 4968 is not an intended result of the statute. Accordingly, we encourage the IRS and Treasury to consider the purpose of Section 4968 in interpreting these provisions and to adopt a rule exempting from the tax assets and income that clearly benefit organizations not subject to tax and may not be used for the benefit of an applicable educational institution. While we also expect that there are ways for tax-exempt organizations and institutions to modify their structures in order to avoid these unintended consequences, we believe undertaking such measures should not be necessary to avoid this

[143] Prop. Treas. Reg. Section 53.4968-1(c)(3)(i).

[144] *Id.*

unintended result. To the extent the IRS and the Treasury believe an amendment to the statute would be necessary in this regard, we recommend that such amendment be sought.

5. *Taxable Entities/Double-Counting*

Section 4968 does not preclude the assets or income of a taxable corporation from being attributed to an educational institution. The statute states simply that assets and net investment income of any related organization with respect to an educational institution shall be treated as assets and net investment income, respectively, of the educational institution.[145] Thus, in the case of a taxable corporation that is controlled by a college or university within the meaning of Section 4968(d), inclusion is seemingly mandated. This result appears to be required despite the fact that there could in fact be three separate layers of tax on such income: U.S. federal income tax at the corporate level on the corporation's income (both investment and active business); excise tax on the net investment income of the corporation, which is included as net investment income of the education institution itself; and excise tax on any dividends paid by the corporation to the educational institution. Further, in the case of distributions paid to the educational institution, the dividends would seemingly be included in net investment income even if the assets of the taxable corporation that give rise to the distribution are not investment assets in any traditional sense.

The Preamble acknowledges that investment income of a corporation controlled by an educational institution is subject to corporate income tax. Accordingly, the Preamble states that Treasury and the IRS do not consider it consistent with Congressional intent to tax this income again under Section 4968.[146] It is unclear how that view should be implemented and how it should be reconciled with the statutory language. The issues arise in a number of different contexts including the treatment of domestic taxable corporations controlled by an educational institution. Similar issues arise in the treatment of foreign investment income earned by educational institutions that is subject to foreign tax and income earned through foreign corporations that are controlled and those for which the educational institution is a U.S. shareholder.[147]

For a domestic taxable corporation controlled by the educational institution, we believe that there are two approaches: a "**look-through approach**" and a "**cash approach**." Under the look-through approach, the Final Regulations could apply the literal language of the statute and treat the educational institution as if it owned the controlled corporation's assets and earned its investment income directly. Under this approach, in order to follow the Congressional intent stated above, the Final Regulations would need to provide that the investment income subject to corporate income tax is not also subject to tax under Section 4968. A basis for this position would be to treat the corporate income tax as akin to the tax on UBTI. The tax rate under the corporate income tax and Section 511 are the same. Additionally, the tax under Section 511 serves as an analog for the corporate income tax.

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[145] Section 4968(d)(1).

[146] Preamble at 31801.

[147] Further discussion of the foreign issues is in Part III.F below.

In addition, under the look-through approach, the Final Regulations would need to address the treatment of any dividends paid by the controlled corporation. Consider a controlled corporation that derives income both from an active business and from investment assets. Because the income from the investment assets is subject to corporate income tax (and possibly also excise tax), any dividends or gain upon sale of the stock attributable to that investment income should be exempt from the tax under Section 4968 if the policy objective is not to subject that income to a further level of tax.

Active income of the controlled corporation is also subject to corporate income tax and therefore arguably dividends attributable to active income should not be subject to excise tax. However, dividends from non-controlled domestic corporations with active income are clearly investment income. One could argue that dividends arising from active income of a controlled corporation are no different than dividends derived from a non-controlled corporation. But, the statutory attribution of the assets and income to the educational institution under Section 4968 could be viewed as exempting or disregarding these dividends as no such dividends would arise if the educational institution owned the domestic corporation's assets directly.

Exempting or disregarding dividends arising from active income of a domestic controlled corporation could possibly encourage educational institutions to make investments in active businesses through controlled corporations as compared with non-controlled corporations. For example, educational institutions would be encouraged to acquire investments in pass-through entities engaged in active businesses through wholly-owned corporations. The active income of the corporation would be subject to corporate income tax, as would any investment income of the corporation, but under a look-through approach that did not impose excise tax on investment income subject to corporate income tax and that exempted or disregarded dividends, no tax under Section 4968 would be payable. In addition, any approach that required allocating a dividend as between the portion of the dividend deriving from investment income of the controlled corporation as compared with active income of the controlled corporation would involve considerable complexity.

Under the cash approach, the Final Regulations would provide that in the case of controlled corporations, net investment income is not taken into account until the educational institution receives a dividend or the stock is sold. Essentially, this approach would treat the ownership of a controlled corporation in a similar manner to the treatment of a non-controlled corporation, as recommended in our Prior Report.[148] This approach would also seemingly stray from the statute which requires the assets and investment income of a controlled entity to be treated as if earned directly by the educational institution. The cash approach would not prevent double taxation of the corporation's investment income unless the dividends and gain attributable to the investment income were not subject to tax under Section 4968. To address this issue, the rules could provide for a "look through" to determine what portion of a dividend or capital gain was attributable to net investment income of the controlled corporation. As noted above, there would be considerable complexity in such a look-through rule. Moreover, as is the case with the treatment of non-controlled corporations, but unlike the treatment under a look-through approach that exempted or

[148] Prior Report at 77.

disregarded dividends, the cash approach would impose tax on dividends arising from active income of the controlled corporation unless rules were implemented to avoid that result. And if the source of income giving rise to a dividend were determined on a look-through basis, this could create disparate treatment of dividends from controlled corporations and non-controlled corporations unless the same rule were to apply consistently.

Regardless of the approach taken, the Final Regulations should address the treatment of entities that are controlled but not wholly-owned. Section 4968 does not explicitly state that in taking into account the assets and net investment income of any related organizations, an educational institution is only treated as owning its proportionate share of the underlying assets of a controlled entity.

Consider an educational institution with an investment portfolio that includes a greater than 50 percent ownership interest in investment vehicles in which other persons unrelated to the educational institution hold the remaining equity interests. Examples include separate "silos," "alternative investment vehicles," or "blocker" entities in private equity fund structures and "funds of one" in which the other equity holder is the manager of the underlying investment portfolio. In such a case, these vehicles are organized in arms-length commercial transactions pursuant to which the equity holders invest their own capital, and in the case of a manager, provide services to the vehicle. These equity holders have contractual (or in the case of a corporate entity, statutory) entitlements to a return of their contributed capital and their shares of the vehicle's profits, as specified in the entity's governing agreement. Adoption of the Section 512(b)(13)(D) control test, coupled with a rule that requires all of the assets and net investment income of the controlled entity to be taken into account by the educational institution, will cause such assets and net investment income to be subject to the Section 4968 excise tax as well as federal income tax with respect to the portion thereof that is allocated to, or indirectly owned by, taxable investors unrelated to the educational institution.

It seems unlikely that Congress intended an educational institution to be required to include as its own assets more than its proportionate share, especially in circumstances where the institution would not have sufficient control to divert those assets to itself. The carve-out in the Proposed Regulations intended to provide relief for educational institutions with Section 509(a)(3) Type III supporting organizations suggests that the IRS and Treasury are amenable to considering such a concern, and we recommend that they do so for controlled but not wholly-owned taxable corporations and partnerships as well.[149]

Recommendation: We recommend that the Treasury and the IRS clarify the general approach to the application of the excise tax in the context of controlled domestic taxable corporations. We further recommend that any inclusion of the assets and income of a domestic corporation (or partnership) that is controlled (within the meaning of Section 4968(d)) but not wholly-owned by an educational institution be based only on its percentage ownership of the

[149] *See* Preamble at 31802-03.

corporation. This rule should be adopted regardless of the approach taken to implementation of the look-through rule for controlled corporations under Section 4968(d).

F. Income from Foreign Operations and Subsidiaries

Similar issues to those discussed with respect to controlled for-profit domestic corporation above in Part III.E.5 of this Report are also present in the context of foreign activities and investments of educational institutions.

The first issue concerns the appropriate treatment of investments made outside the United States whether directly, through a branch or through an entity that is tax transparent for U.S. purposes. In that case, the principal question is whether any investment income earned through such activities should be exempt from tax under Section 4968 if that income is subject to a foreign income tax.

The second issue to be addressed concerns the treatment of foreign entities that are tax opaque for U.S. income tax purposes and are controlled by the educational institution.

The final issue to be addressed concerns the treatment of investments in entities that are CFCs in which the educational institution is a U.S. shareholder but does not hold a controlling interest. The issues are particularly pertinent in the case of Subpart F income ("**Subpart F Income**") inclusions under Section 951 and global intangible low-taxed income ("**GILTI**") inclusions under Section 951A.

1. Foreign Operations

Where an educational institution conducts foreign operations through a tax transparent vehicle—whether directly, through a branch or through a foreign entity that is treated as a partnership or disregarded entity for U.S. federal income tax purposes—there are different potential approaches that could be taken with respect to the Section 4968 excise tax. The Proposed Regulations appear to include in gross investment income, income of foreign operations and subsidiaries that is not treated as UBTI.[150] Under this approach, the resulting net investment income would be subject to the excise tax as well as any applicable foreign income tax. No credit against the excise tax is available for the foreign taxes paid. This rule would apply whether or not the income is earned in a fiscally opaque entity for foreign income tax purposes. A question arises as to whether the fact that the net investment income is subject to foreign income tax should exempt such income from the excise tax.

One approach is that this income should be treated similarly to UBTI, that is, excluded from the excise tax under the theory that it is already subject to income tax. Under this reasoning, the net investment income earned from foreign investments would be excluded from the excise tax under Section 4968 to the extent such amounts are already subject to foreign income tax. For

[150] Prop. Treas. Reg. Section 53.4968-1(b)(2); Section 4940(c) and Treas. Reg. Sections 53.4940-1(c) through (f). This approach is consistent with the general U.S. tax treatment of investments through tax transparent entities and there does not appear to be a basis to deviate from that treatment.

example, investment income of a hybrid entity (treated as taxable in the foreign jurisdiction) owned by an educational institution, which was subject to tax under the income tax laws of the foreign jurisdiction would be excluded from net investment income under Section 4968(c). As discussed above in Part III.E.5 in the context of for-profit domestic subsidiaries, legislative history suggests that Congress did not intend double-taxation under Section 4968. However, it is not clear that Congress' intended eschewal of double-taxation in the context of Section 4968 meant that Section 4968 should not apply merely because income is subject to foreign income tax.

As such, a second approach is to treat this foreign investment income no differently than domestic investment income under general income tax principles, which would treat the educational institution as earning its allocable share of any items of investment income or expense whether subject to tax in the local jurisdiction or not.[151] The argument for treating U.S. corporate income tax the same as the tax on UBTI is arguably stronger, as the rates are the same and they are essentially substitutes for each other, as compared with the argument for treating a foreign income tax (with potentially different rates and rules) the same as the tax on UBTI would be. We note that under this second approach, any items of income other than investment income would, by definition, not be subject to the Section 4968 excise tax. Similarly, if a hybrid entity's activities were to give rise to exempt function income, such income would be excluded based on our above recommendations.[152]

2. CFCs Controlled by an Educational Institution

Section 4968(d) and the rules in the Proposed Regulations with respect to controlled entities do not distinguish between foreign and domestic organizations. The income and assets of a controlled entity, whether domestic or foreign, are considered as income and assets of the educational institution. Accordingly, CFCs that are controlled by an educational institution within the meaning of Section 4968(d) present similar issues to those discussed above in Part III.E.5, involving controlled domestic taxable corporations with respect to the manner in which the assets and income are deemed attributable to the educational institution. Because the statute does not distinguish between foreign and domestic controlled corporations, it would appear that the same overall approach should be adopted.

CFCs controlled by an educational institution present additional issues, however. First, both possible approaches (look-through approach and cash approach) to the treatment of domestic controlled corporations attempt to prevent double taxation of investment income on the basis that it is already subject to U.S. corporate income tax. As noted above, it is unclear that a foreign income tax should be considered the equivalent of the U.S. corporate income tax. In particular, to the extent that the foreign tax rate is lower than the U.S. corporate income tax rate, exempting the investment income of a controlled CFC from tax under Section 4968 would encourage educational institutions to hold their investments through foreign corporations.

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[151] *See* Sections 704(a), (b).

[152] Part III.D.2 of this Report.

Second, any rules adopted in this area would need to address the application of the Subpart F and GILTI inclusions described below in Part III.F.3. Under the look-through approach, it would appear that Subpart F and GILTI inclusions should be disregarded. Under the cash approach, the regulations for CFCs controlled by an educational institution would need to address similar issues with respect to Subpart F and GILTI inclusions as those described below for CFCs that are not controlled by the educational institution. Under either approach, similar to the issue with respect to domestic controlled corporations, the Final Regulations should address the treatment of CFCs that are controlled but not wholly-owned. As discussed above,[153] avoiding double-counting of assets should mean that the educational institution is treated as owning a proportionate share of the underlying assets of the controlled subsidiary. Specifically, in those cases in which the CFC is controlled, but not wholly-owned, the educational institution should not be required to include as its assets and income more than its proportionate share of the assets and income of the CFC.

Recommendation: We recommend that Treasury and the IRS clarify the basic approach to the application of the Section 4968 excise tax in the context of CFCs in which an educational institution owns a controlling interest. We further recommend that any inclusion of the assets and income of a CFC that is controlled (within the meaning of Section 4968(d)) but not wholly-owned by an educational institution be based only on its percentage ownership of the CFC. This approach is consistent with the rules applicable to domestic controlled organizations.

3. CFCs Not Controlled by an Educational Institution

Additional issues arise in respect of Subpart F Income and GILTI from CFCs that are not controlled by an educational institution. Specifically, issues include whether such income should be included in the determination of net investment income (and if so, when) or alternatively, whether such income should be excluded from net investment income and instead educational institutions should simply be taxed on distributions from, and sales of stock of, CFCs. In general, we recommend that Treasury and the IRS provide guidance with respect to the treatment of income earned by CFCs for purposes of Section 4968 in the Final Regulations. We discuss below relevant considerations.

a. Subpart F Income

In proposed regulations addressing inclusions under Section 965, Treasury and the IRS asserted that Subpart F Income included under Section 951(a)(1) is included in the determination of net investment income under Section 4940.[154] The preamble to those proposed regulations provides that "an inclusion under section 951(a)(1), including a section 965(a) inclusion, generally is included in the calculation of gross investment income of a private foundation."[155] Moreover,

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[153] *See* Part III.E.5 of this Report.

[154] Notice of Proposed Rulemaking REG-104226-18, 83 Fed. Reg. 39514, 39519 (August 9, 2019).

[155] *Id*.

the amount is included on the same basis as income is included for taxable corporations. A similar view is expressed in Treas. Reg. §1.965-3(f)(4).[156]

There is no other authority directly addressing this issue.

Presumably, applying the same analysis as in the Section 965 context and given that Section 4968(c) adopts rules similar to those in Section 4940(c), Subpart F Income would be included in net investment income as income similar to a dividend for purposes of Section 4968. In our Prior Report,[157] we noted that the definition of net investment income in Section 4940(c) may be sufficiently broad to cover Subpart F Income, since investment income includes "income from sources similar to" those specifically enumerated.[158] In addition, this view reflects the economic reality that the Subpart F regime causes U.S. shareholders to recognize the functional equivalent of a dividend from the foreign corporation.[159] Like a dividend, U.S. shareholders take into account Subpart F Income only to the extent of the foreign corporation's earnings and profits.

To the extent the preamble to the proposed Section 965 regulations is interpreted as describing the operative rule with respect to Subpart F Income in the context of private foundations, we do not necessarily see a policy reason for treating educational institutions differently on this issue.

Subpart F Income generally consists of movable income, a major category of which is foreign base company income, which includes foreign personal holding company income and consists of investment income such as dividends, interest, rents and royalties.[160] As such, since Subpart F Income generally consists of passive investment-type income, it would arguably be the more appropriate policy approach for the educational institution to include such amounts in its income for purposes of computing net investment income on a current basis, i.e., when such amount is includible under Section 951.

There are two further principal issues that need to be addressed. The first, which is common to all foreign income, is whether the income included under Subpart F should be excluded from tax under Section 4968 because it has been subjected to a foreign tax. The issues are identical to those presented with respect to other foreign income, as discussed above in Part III.F.2 and should be addressed in the same manner. Second, the rules would need to address the treatment of dividends from the CFC. If the CFC has income other than Subpart F Income, the portion of any distributions or gain on sale that are attributable to that income would need to be determined,

[156] Treas. Reg. §1.965-3(f)(4) provided that the deduction provided in Section 965(c) is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income.

[157] Our Prior Report's discussion on this topic addressed only the Section 965 transition tax; however, similar reasoning to that in our Prior Report regarding Subpart F income as well as GILTI income could also apply in the context of both Section 4940 and Section 4968.

[158] *Id.*

[159] Prior Report at 38.

[160] Section 952; Section 954.

insofar as the existing rules do not already do so. This issue is similar to the issues discussed above in Part III.E.5 with respect to controlled domestic corporations that have both investment income and other income. Additionally, any rules would need to address the rules under Section 959 which exclude from income previously taxed earnings and profits.

An alternative view would be to recognize an item of investment income only when a distribution is made from the CFC. This approach would avoid income inclusions in advance of the receipt of cash. However, it would provide an incentive for educational institutions to hold investment assets through CFCs which such institutions do not control. That incentive could thwart the purposes of Section 4968 by permitting the educational institution to defer indefinitely the tax on investment income earned through the CFC.[161] In addition, as discussed both in Part III.E.5 above and in Part III.F.3.b below, such an approach would also have to consider whether the full amount of any distribution would be included in net investment income, or whether a further look-through would apply such that net investment income would include only the portion of any such distribution arising from the investment income of the underlying CFC.

b. GILTI

Similar issues are presented by the GILTI rules. In Notice 2018-67,[162] the IRS and Treasury reason that GILTI inclusions should be treated in the same manner as an inclusion of Subpart F Income for purposes of the UBTI rules. Accordingly, the Notice provides that an inclusion of GILTI will be treated as a dividend which is generally excluded from UBTI under Section 512(b)(1).[163] Treating an inclusion of GILTI as a dividend supports its inclusion in net investment income under Section 4968.

Despite Notice 2018-67, one could argue that GILTI is in many cases not in the nature of investment income. GILTI is generally the active business income of the company minus an allowable return on tangible assets. For certain companies, the GILTI rules could require inclusion of nearly 100 percent of the profits of the company. It would seem contrary to the purpose of Section 4968, which targets investment-type income specifically, to tax such active business income on the basis that the GILTI inclusion bears resemblance to Subpart F Income and dividend income.[164] In fact, most sources of investment income are already excluded from GILTI because they are Subpart F Income.[165] To the extent that the inclusion of income of CFCs under GILTI is based upon a look through to the sources of the income—as it presumably would be if the educational institution controlled the CFC—the result of including GILTI on the same basis as Subpart F seems inappropriate. Subpart F Income is generally passive and would be included in

[161] We note that this potential may exist with respect to investments in passive foreign investment companies within the meaning of Section 1297, which do not require current inclusion in all cases. The issues presented passive foreign investment companies are beyond the scope of this report.

[162] 2018-36 I.R.B. 409.

[163] *Id.* at 32.

[164] Section 951A(f).

[165] *See* Section 951A(c)(2)(A)(i)(II).

net investment income if earned directly. GILTI generally is derived from active business income which would be excluded from the tax.

Thus, to the extent the Final Regulations take an approach in the case of non-controlled CFCs that would include Subpart F Income in the net investment income of an educational institution when includible under Section 951, the IRS and Treasury should consider whether GILTI inclusions should also be taken into account when includible under Section 951A.

To the extent the Final Regulations adopt a cash approach in the case of non-controlled CFCs (and do not tax GILTI when it is includible under Section 951A), several further issues arise. First, when the CFC makes a distribution, should the entire distribution be taxed or only the portion attributable to net investment income of the CFC? This issue is similar to the issue presented in the case of foreign corporations controlled by the educational institution and discussed above in Part III.F.2. If only the portion of a distribution attributable to net investment income of the CFC were taxable, the approach could encourage investment in foreign corporations rather than domestic corporations, as the entire dividend from a non-controlled domestic corporation is subject to the excise tax.

Second, actual distributions from CFCs are generally excluded from income for corporations pursuant to the tax rules governing previously taxed earnings and profits under Section 959. Thus, a cash approach would require additional rules that would effectively "turn off" the previously taxed earnings and profits rules in the context of Section 4968.

Third, as discussed above in the context of Subpart F Income, as compared with taxing GILTI when it is includible under Section 951A, the approach permits educational institutions to defer tax on income earned through foreign corporations, which could encourage the development of investment vehicles outside the United States that could be exploited to undermine Section 4968.

Recommendation: We recommend that Treasury and the IRS clarify the basic approach to the application of the Section 4968 excise tax in the context of CFCs in which an educational institution is a U.S. shareholder, but does not own a controlling interest-- both with respect to Subpart F income and GILTI.