DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 53

[TD 9917]

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations for determining the excise tax applicable to the net investment income of certain private colleges and universities. The regulations affect certain private colleges and universities.

DATES:

Effective Date: These regulations are effective on October 14, 2020.

Applicability Date: For date of applicability, see § 53.4968–4.

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SUPPLEMENTARY INFORMATION:

Background

This document amends the Foundation and Similar Excise Tax Regulations (26 CFR part 53) by adding final regulations under section 4968 of the Internal Revenue Code (Code). Section 4968 was added to the Code by section 13701 of Public Law 115–97 (131 Stat. 2054, 2167–68 (2017)), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 4968(a) imposes on each applicable educational institution, as defined in section 4968(b)(1), an excise tax equal to 1.4 percent of the institution's net investment income, determined under section 4968(c). Further, section 4968(d) treats a portion of certain assets and net investment income of certain related organizations as assets and net investment income of the educational institution.

Section 4968(b)(1) defines the term ''applicable educational institution'' as an eligible educational institution (as defined in section 25A(f)(2)) that, during the preceding taxable year, had at least 500 tuition-paying students, more than 50 percent of whom were located in the United States, that is not a state college or university as described in the first sentence of section 511(a)(2)(B), and that had assets (other than those assets used directly in carrying out the institution's exempt purpose) the aggregate fair market value of which was at least $500,000 per student of the institution.

Section 4968(b)(2) provides that, for purposes of section 4968(b)(1), the number of students of an institution (including for purposes of determining the number of students at a particular location) 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(c) provides that, for purposes of section 4968, ''net investment income'' is determined under rules similar to the rules of section 4940(c).

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

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

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

In June 2018, the Department of the Treasury (Treasury Department) and the IRS issued Notice 2018–55, 2018–26 I.R.B. 773, to provide interim guidance on certain issues related to the application of the tax imposed by section 4968. Specifically, Notice 2018–55 stated that, in the case of property held on December 31, 2017, and continuously thereafter to the date of its disposition, the Treasury Department and the IRS intended to propose regulations stating that basis for purposes of determining gain (but not loss) is deemed to be not less than the fair market value of such property on December 31, 2017, plus or minus all adjustments after December 31, 2017, and before the date of disposition, consistent with the regulations under section 4940(c). Notice 2018–55 additionally stated that the Treasury Department and the IRS expected the proposed regulations to provide that losses from sales or other dispositions of property generally would be allowed only to the extent of gains, with no capital loss carryovers or carrybacks, and that losses from sales or other dispositions of property by related organizations will be allowed to offset overall net gains from other related organizations or the applicable educational institution.

On July 3, 2019, the Treasury Department and the IRS published a notice of proposed rulemaking in the **Federal Register** (REG–106877–18, 84 FR 31795) that contained proposed regulations regarding the requirements of section 4968, including the manner for determining the excise tax applicable to the net investment income of certain private colleges and universities. The proposed regulations incorporated the provisions set forth in Notice 2018–55. The proposed regulations also provided definitions for several of the terms necessary for an educational institution to determine whether the section 4968 excise tax is applicable to it, including the terms ''student,'' ''tuition-paying,'' ''located in the United States,'' and ''assets used directly in carrying out an institution's exempt purpose.'' Eighteen comments were received in response to the proposed regulations, one of which was the collective comment of forty educational institutions likely to be subject to this excise tax. No public hearing was requested or held.

After consideration of the comments received, the proposed regulations

[1] Section 4968(d)(1) erroneously cross references section 4968(b)(1)(C). The correct cross reference should be to section 4968(b)(1)(D). See Joint Committee on Taxation, ''General Explanation of Public Law 115–97'' (JCS–1–18), December 2018, at 290, n. 1357.

under section 4968 are adopted as final regulations as modified by this Treasury Decision. The major areas of comment and the revisions to the proposed regulations are discussed in the Summary of Comments and Explanation of Revisions. Eight commenters voiced objections to the Code section itself. No regulatory response to these comments is appropriate. Accordingly, these comments are not discussed in the Summary of Comments and Explanation of Revisions. All comments are available for public inspection at *www.regulations.gov* or on request.

Summary of Comments and Explanation of Revisions

These final regulations provide guidance on the tax imposed by section 4968 and the entities that are subject to the tax.

1. Applicable Educational Institution

Section 4968(b)(1) defines the term ''applicable educational institution,'' in part, as an eligible educational institution defined in section 25A(f)(2). Consistent with the statute, the proposed regulations provided that the term ''applicable educational institution'' means any eligible educational institution (as defined in section 25A(f)(2) and § 1.25A–2(b)): (1) That had at least 500 tuition-paying students attending the institution during the preceding taxable year; (2) more than 50 percent of whose tuition-paying students are located in the United States; (3) that is not described in the first sentence of section 511(a)(2)(B) (relating to state colleges and universities); and (4) the aggregate fair market value of the assets of which at the end of such preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purpose) is at least $500,000 per student attending the institution.

Two commenters addressed the definition of applicable educational institution. The first commenter recommended that the final regulations provide additional guidance to clarify that separate, but affiliated, educational institutions 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. These final regulations do not adopt this recommendation, because both section 4968(b)(1) and section 25A(f)(2) refer to individual institutions and neither contains any provisions for aggregating affiliated institutions for purposes of determining the number of students at an institution. The only aggregation in section 4968 is the requirement to treat certain assets and net investment income of related organizations as the assets and net investment income, respectively, of the institution.

The second commenter stated that, for purposes of defining ''eligible educational institution,'' the final regulations should not include a reference to the regulations at § 1.25A–2(b) and should use only the statutory definition contained in section 25A(f)(2). Section 1.25A–2(b) provides that an eligible educational institution means, in general, a college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) as in effect on August 5, 1997 (generally all accredited public, nonprofit, and proprietary postsecondary institutions) that (1) is participating in a Federal financial aid program under title IV of the Higher Education Act of 1965 or (2) is certified by the Department of Education as eligible to participate in such a program but chooses not to participate.

The commenter explained that there are several educational institutions whose organizational documents and mission prohibit them from applying for or receiving Federal funds (including accepting funds as part of a student Federal financial aid program under Title IV of the Higher Education Act of 1965). The commenter asked that applicability of section 4968 be determined based on the actions of an institution rather than by a Department of Education certification that is focused on whether the students of an institution can claim an individual tax credit under section 25A for expenses to attend the institution, which the commenter sees as being incompatible with both the terms of section 25A and the mission of such institutions.

Although the Treasury Department and the IRS appreciate the position of the commenter, section 4968 expressly defines applicable educational institution by reference to section 25A(f)(2). Section 25A(f)(2) provides that the term ''eligible educational institution'' means an institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on the date of the enactment of section 25A, and that ''is *eligible* to participate in a program under title IV of such Act.''

If the final section 4968 regulations did not include a reference to § 1.25A–2(b), an educational institution would still be ''eligible to participate in a program under title IV of such Act'' as long as it satisfied all of the requirements of that Act even if it chose not to participate in such a program and even if it was not certified by the Department of Education as eligible to participate in such a program. Thus, deleting the reference to § 1.25A–2(b) would not address the commenter's concerns. Further, § 1.25A–2 was adopted in 2002, and Congress is presumed to have been aware of the regulations when section 4968 was enacted. Congress did not express any intent in the legislative history of section 4968 for the regulations under section 25A to be disregarded for purposes of defining eligible educational institution. In addition, it would be very difficult for the Treasury Department and the IRS to provide in the regulations under section 4968 that the IRS is following a definition of eligible educational institution that is consistent with the statutory language of section 25A(f)(2) without also incorporating the regulations under section 25A unless there was specific language in section 4968 with which the regulations were in conflict, and that is not the case here. Lastly, the Treasury Department and the IRS understand that the number of educational institutions that do not participate in the Federal programs provided in the Higher Education Act or that are not certified as eligible to participate in the programs is very small, and it would be burdensome for the IRS to follow one definition of eligible educational institution for purposes of section 25A and another under section 4968 when both provisions are dependent on section 25A(f)(2).

Thus, these final regulations adopt the definition of applicable educational institution as proposed.

2. Student

The proposed regulations defined ''student,'' based in part on section 25A(b)(3) and the Higher Education Act, as a person enrolled in a degree, certification, or other program (including a program of study abroad approved for credit by the eligible educational institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution, and who is not enrolled in an elementary or secondary school.

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

Three commenters addressed the proposed definition of ''student,'' stating that section 4968 does not define the term student but it does provide that, for purposes of determining the number of students of an institution, an educational institution must determine the daily average number of full-time students attending the institution, with part-time students taken into account on a full-time student equivalent basis. Two of these commenters recommended that the definition should include all students attending the institution even if not enrolled in a degree, certification, or other program leading to a recognized educational credential, stating that section 4968 includes students that are taking a less-than half time load and that many of those students are not seeking a degree. The commenters stated that the definition of student for purposes of the Lifetime Learning Tax Credit (LLTC)[2] or the Family Educational Rights and Privacy Act (FERPA)[3] is broader than the definition that applies for purposes of the Higher Education Act and the American Opportunity Tax Credit,[4] which defines those eligible for student loans, and thus is more consistent with and thus appropriate for purposes of section 4968. In addition, two commenters recommended against a definition based on a recognized educational credential, questioning who would decide what constitutes such a credential and whether this would allow potential manipulation by the educational institutions. One other commenter suggested retaining the standard in the proposed regulations.

The Treasury Department and the IRS agree that section 4968 does not expressly state that a person must be enrolled in a degree, certification, or other program to be considered a student. However, section 4968 does require that a student be *attending* the institution: ''. . . the number of students of an institution . . . shall be based on the daily average number of full-time students attending such institution (with part-time students taken into account on a full-time student equivalent basis).''

The Treasury Department and the IRS have concluded that the definition of student provided in FERPA is overly broad, as it includes, for example, individuals who previously attended the educational institution.

However, the LLTC, which provides a tax credit based on certain tuition and fees required ''for the enrollment or attendance of'' an individual at an eligible educational institution ''for courses of instruction of such individual at such institution'' does provide a useful analogy, as it refers to a person who is enrolled, attending, and paying qualified tuition to an institution for courses of instruction at such institution.

Whereas the LLTC includes a requirement that the purpose of the course must be to acquire or improve job skills of the individual, the Treasury Department and the IRS have determined that it would be more appropriate and administrable instead to require that the course be taken for academic credit. Whereas neither an applicable educational institution nor the IRS is likely to know whether a course is taken to acquire or improve job skills of the individual, it should be easy to determine whether a course was taken for academic credit. Furthermore, anyone taking a course for academic credit is using the school's resources to receive the specific time and attention of the school's faculty for his or her individual instruction. Thus, it is appropriate to include taking a course for academic credit as a component of the definition of student for purposes of section 4968.

However, under the definition, a student, whether full time or part time, must be charged tuition at a rate that is commensurate with the rate charged to students enrolled for a degree. The Treasury Department and the IRS have concluded that this is necessary for a part-time student to be considered as attending the institution on an ''equivalent basis'' to a full-time student.

Thus, these final regulations define the term ''student'' for purposes of section 4968 as a person who is enrolled and attending a course for academic credit from the institution and who is being charged tuition at a rate that is commensurate with the tuition rate charged to students enrolled for a degree. No inference is to be drawn from this definition with regard to the definition of student for other purposes, including for purposes of applying section 25A.

These final regulations also adopt the portion of the definition of ''student'' found in the proposed regulations providing that the number of students of an educational institution (including for purposes of determining the number of students at a particular location) is based on the daily average number of full-time students (with part-time students taken into account on a full-time student equivalent basis). The standards for determining whether a student attends part-time or full-time and for calculating full-time equivalents and the daily average number of full-time students are determined by each educational institution. However, the standards may not be lower than the minimum applicable standards established by the Department of Education under the Higher Education Act of 1965 (20 U.S.C. 1088), as amended.

3. Tuition-Paying

The proposed regulations provided that the term ''tuition-paying'' means the payment of any tuition or fees required for the enrollment or attendance of a student for a course of instruction at an eligible educational institution. The proposed regulations stated that this does not include any separate payment for supplies or equipment required during a specific course once a student is enrolled in and attending the course or the payment of room and board or other personal living expenses. In addition, the proposed regulations provided that whether a student is ''tuition-paying'' is determined after taking into account any scholarships provided directly by the educational institution and any work study programs operated directly by the

[2] The Lifetime Learning Credit, found in section 25A(c), provides a tax credit equal to 20 percent of up to $10,000 of ''qualified tuition and related expenses'' paid by the taxpayer during the taxable year to acquire or improve job skills. Section 25A(f)(1) defines qualified tuition and related expenses as tuition and fees required for enrollment or attendance at an eligible educational institution for courses of instruction at such institution.

[3] The Family Educational Rights and Privacy Act (FERPA) (20 U.S.C. 1232g; 34 CFR part 99) is a Federal law that protects the privacy of student education records. It defines the term ''student'' as any individual who is or has been in attendance at an educational agency or institution, including at elementary and secondary school levels, and regarding whom the agency or institution maintains education records.

[4] The American Opportunity Tax Credit, found in section 25A(b), provides a tax credit equal to the sum of 100 percent of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year (for education furnished to the eligible student during any academic period beginning in such taxable year) as does not exceed $2,000, plus 25 percent of such expenses so paid as exceeds $2,000 but does not exceed $4,000. Section 25A(b)(3) defines an eligible student for purposes of the American Opportunity Tax Credit as a student who meets the requirements of section 484(a)(1) of the Higher Education Act of 1965 (20 U.S.C. 1091(a)(1)), as in effect on the date of the enactment of section 25A, and is carrying at least ½ the normal full-time work load for the course of study the student is pursuing.

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.

Three commenters discussed the meaning of ''tuition-paying.'' One commenter expressed a concern that smaller educational institutions might modify their financial aid programs to offer fewer partial scholarships and more full scholarships to fall under the threshold of having 500 tuition-paying students. The Treasury Department and the IRS have determined that a modification to the regulations for this purpose is not necessary because any definition of tuition-paying may lead to this result and because the same definition of tuition-paying should apply regardless of the size of the institution.

Another commenter recommended that a student should be considered ''tuition-paying'' regardless of the source of tuition funds, except that an eligible educational institution that does not charge tuition to any student would not be considered to have any tuition-paying students. These final regulations do not adopt this suggestion because the statute does not refer to tuition ''charged,'' rather it refers to tuition ''paid.''

The third commenter asked whether the term ''scholarships'' in the proposed regulations was intended to include Pell Grants and other forms of Federal and state student financial aid as well as non-governmental grants made on behalf of students, recommending that these grants from government and non-government sources not be treated as the payment of tuition on behalf of students. The Treasury Department and the IRS agree that grants or scholarships made by Federal, state, and local governments should be disregarded when determining whether a student is tuition-paying. Grants or scholarships made by Federal, state, and local governments generally are governed by legislation, are intended to make a college education more affordable for all potential students, and generally are based on criteria that the government sets (such as a determination of financial need), applied without regard to which educational institution the student attends or the cost of the education. Pell Grants and other Federal grants are awarded and administered by the Department of Education, which determines each student's financial need and eligibility for the grant. Finally, almost all educational institutions, whether private or public, use Federal and state grants to offset the cost of tuition, and therefore it would be fundamentally unfair to include these government grants as payment of tuition by or on behalf of a student in determining whether an educational institution is liable for the excise tax imposed by section 4968.

Thus, these final regulations adopt the definition of ''tuition-paying'' found in the proposed regulations, which concluded that scholarships awarded by the institution are not tuition ''paid'' on behalf of the student, whereas scholarships from third parties essentially are payments of the student's tuition, but add that whether a student is tuition-paying is also determined after taking into account grants made by the Federal government or any state or local government.

4. Located in the United States

The proposed regulations provided that the term ''located in the United States'' refers to the location of a student, and that a student is considered to have been located in the United States if the student resided in the United States for at least a portion of the time the student attended the institution during the educational institution's preceding taxable year.

The preamble to the proposed regulations provided three examples relating to whether a student is considered to have been located in the United States. In the first example, a student who attended an educational institution in the preceding taxable year and who is a citizen of a foreign country is considered to have been a student located in the United States if the student resided in the United States for at least a portion of the time the student attended the educational institution in the preceding taxable year. In the second example, a student attending the educational institution in the preceding taxable year who was studying abroad in a foreign country is considered to have been a student located in the United States if the student resided in the United States for at least a portion of the time the student attended the educational institution. The third example illustrates that, if a student did not reside in the United States for any portion of the time the student attended the educational institution during the preceding taxable year, then that student would not be considered to have been located in the United States for purposes of section 4968(b)(1)(B). The proposed regulations asked for comments on whether further guidance is needed relating to whether a student is considered to have been located in the United States in a preceding taxable year.

One commenter addressed the definition of ''located in the United States.'' This commenter recommended that each institution be permitted to determine whether a student is located in the United States using any reasonable approach, as long as it was consistently used. However, the commenter said that the approach would have to consider students who spend substantial time in the United States attending classes as located in the United States.

The proposed rule contemplated that educational institutions could determine whether a student resided in the United States for at least a portion of the time that the student attended the institution during the institution's preceding taxable year using any reasonable method, but these final regulations make that explicit. The final regulations otherwise maintain the rule as proposed.

5. Assets Used Directly in Carrying Out an Institution's Exempt Purpose

a. In General

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

For purposes of section 4942, a private foundation must determine its minimum investment return as part of its calculation of its distributable amount for any taxable year. Minimum investment return is defined in section 4942(e) as five percent of the excess of the aggregate fair market value of all assets of the foundation ''other than those which are used (or held for use) directly in carrying out the foundation's exempt purpose,'' over the acquisition indebtedness with respect to such assets.

Because section 4968 contains a phrase similar to the language used in section 4942 (other than the omission of the parenthetical ''(or held for use)''), the proposed regulations generally followed § 53.4942(a)–2(c) for purposes of determining whether an educational institution's assets are used directly in carrying out the institution's exempt purpose, but not including any assets that would be considered ''held for use'' for section 4942 purposes.

More specifically, the proposed regulations provided that an asset is used directly in carrying out an institution's exempt purpose only if the asset is actually used by the institution in carrying out its exempt purpose. Whether an asset is used directly by the institution to carry out its exempt purpose must be determined based on all the facts and circumstances. If property is used for an exempt purpose and for other purposes, and the exempt use represents 95 percent or more of the total use, the property is considered to be used exclusively for an exempt purpose. If the exempt use of such property represents less than 95 percent of the total use, the institution must make a reasonable allocation between exempt and nonexempt uses.

The proposed regulations included examples of assets that are used directly in carrying out an institution's exempt purpose, stating that they include, but are not limited to: (1) Administrative assets, such as office equipment and supplies used by the institution directly in the administration of its exempt activities; (2) real estate or the portion of any building used by the institution directly in its exempt activities; (3) physical property such as paintings or other works of art owned by the institution that are on public display, fixtures and equipment in classrooms, research facilities and related equipment that, under the facts and circumstances, serve a useful purpose in the conduct of the institution's exempt activities; (4) the reasonable cash balances necessary to cover current administrative expenses and other normal and current disbursements directly connected with the educational institution's exempt activities (and, for this purpose, the proposed regulations provided a safe harbor for determining a reasonable cash balance: The portion of an educational institution's actual cash balances at the end of a year that does not exceed 1.5 percent of the fair market value of the institution's non-charitable use assets, determined without regard to any reduction for reasonable cash balances); and (5) any property the educational institution leases to other persons at no cost (or at a nominal rent) to the lessee in furtherance of the institution's exempt purposes.

The proposed regulations also provided the following examples of assets not considered to be used directly in carrying out an institution's exempt purpose: (1) Assets that are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or leased real estate), even if the income from such assets is used to carry out such exempt purpose; and (2) property (such as offices) used for the purpose of managing the institution's endowment funds.

The proposed regulations asked for comments on whether the use of the principles of the section 4942 regulations creates any concerns. Commenters asked that the final regulations expand the list of assets considered used directly in carrying out an institution's exempt purpose to include those that are ''held for use'' as well as including certain intangible assets and certain assets of functionally related businesses. Commenters also addressed how to calculate a reasonable cash balance that would be considered used directly in carrying out an institution's exempt purpose. In addition, commenters asked whether an asset of a related organization that is treated as an asset of an educational institution by section 4968(d) can be considered used directly by the institution in carrying out its exempt purpose.

b. Assets That Are Held for Use

One commenter asked that the proposed regulations be expanded to include as assets ''used directly in carrying out the institution's exempt purpose'' assets that are ''held for use'' to carry out such purposes, stating that there is no legislative history suggesting that Congress specifically intended to not include the ''held for use'' language contained in section 4942.

Because assets held for use could include a much broader category of assets, such as portions of an endowment fund set aside in some formal or informal way for an exempt purpose, the Treasury Department and the IRS have concluded that the category of assets used directly for an institution's exempt purposes should not be so expanded, especially because the statutory language of section 4968 does not include the ''(or held for use)'' parenthetical language that appears in section 4942. Accordingly, these final regulations do not adopt the commenter's suggestion.

c. Intangible Assets

One commenter requested that the final regulations permit intangible assets, in appropriate cases, to be treated as used directly in carrying out an institution's exempt purpose. The Treasury Department and the IRS agree that, in certain circumstances, intangible assets may be treated as used directly in carrying out an institution's exempt purpose. Thus, these final regulations provide that, to the extent that royalty income would be excluded from net investment income as described in part 6.a.iii. of this Summary of Comments and Explanation of Revisions, the patents, copyrights, and other intellectual property and other intangible property generating such royalty income are treated as assets used directly by the institution in furtherance of its exempt purposes. These final regulations also provide that trademarks on an institution's logo or name and intellectual property donated or sold to the institution are not assets used directly for the institution's exempt purposes.

d. Certain Assets of Functionally Related Businesses

The preamble to the proposed regulations asked for comments on whether and how educational institutions use functionally related businesses in conducting their operations and whether functionally related businesses should be explicitly included or excluded as examples of exempt use assets in the final regulations. One commenter requested that the final regulations provide that non-financial assets used in a functionally related business be considered assets used directly in carrying out an educational institution's exempt purpose. The commenter stated that university theatres that produce plays, student newspapers with circulation revenue or ad sales income, or similar activities that operate as legally separate businesses while buttressing the educational mission of an educational institution are examples of functionally related businesses. The commenter recommended that assets, including intangible assets, of such a functionally related business be considered to be used directly in furthering the educational institution's exempt purpose. The commenter further recommended, however, that working capital or other financial resources relating to such a functionally related business should be considered assets not used directly in furthering the educational institution's exempt purpose.

The Treasury Department and the IRS agree that, in certain circumstances, certain assets of functionally related businesses may be treated as used directly in carrying out an institution's exempt purpose. However, the Treasury Department and the IRS note that the concept of a functionally related business is relevant only for private foundations with respect to the excise taxes imposed under sections 4942 and 4943. Thus, instead of providing a special rule for a non-financial asset of an activity of an educational institution, or of a related organization with respect to the educational institution, that meets the definition of a functionally related business found in § 53.4942(a)–2(c)(3)(iii), the general rule is that an educational institution evaluates each asset based on all the facts and circumstances to determine whether the asset is used directly in furthering the institution's exempt purpose applies.

e. Reasonable Cash Balance

The proposed regulations recognized that, for section 4942 purposes, an amount equal to 1.5 percent of the fair market value of a private foundation's non-charitable use assets (*i.e.,* assets not actually used by an institution in carrying out its exempt purpose), determined without regard to the reduction for the reasonable cash balance, is deemed to be a ''reasonable cash balance'' that is excluded from the asset base used in calculating a private foundation's minimum investment return under section 4942(e). For consistency with the section 4942 rules, the proposed regulations proposed to adopt the same definition as a safe harbor and asked for comments on whether, in light of the differences between the exempt activities and valuation date(s) of a private foundation and an educational institution, a different percentage or other measurement should be used as a reasonable cash balance at the end of the taxable year.

Two commenters stated that the 1.5 percent safe harbor should not be included in the final regulations, because there is a significant difference between the activities, and thus the need for cash for operating expenses, of a private foundation and an educational institution. The commenters indicated that the operating expenses of a private foundation whose exempt activity is awarding grants, and even of an operating private foundation, generally are substantially less than the salaries, maintenance, and other operating expenses of an educational institution with expansive physical facilities and human resources for conducting education and research.

One commenter stated that educational institutions affected by the excise tax under section 4968 vary widely in size and focus, and that their methods for the delivery of educational services—which are the drivers of operating expenses and corresponding cash outflow and timing—vary widely. This commenter also mentioned that some institutions have a summer session with a lower attendance (therefore requiring fewer resources) as compared to their traditional fall or spring sessions, and thus may have a lower cash balance at the end of their taxable year, which generally falls in the middle of summer on June 30th or July 31st. This commenter also stated that ratings agencies might downgrade the credit rating of some institutions based on their having cash on hand of only 1.5 percent of the value of non-exempt use assets, and that bond proceeds for exempt projects must be held in liquid assets. One commenter also stated that the amount required for the reasonable cash needs of the institution should include funds for the expenses of its educational and research functions as well as cash reserves for special projects and bond covenants. Both commenters recommended that the final regulations instead permit educational institutions to determine their own reasonable cash needs as of the end of the taxable year, based on the particular facts and circumstances of that institution.

The Treasury Department and the IRS note that the 1.5 percent safe harbor in proposed § 53.4968–1(a)(4)(ii)(D) was merely a safe harbor and did not prevent an educational institution from establishing under the general facts and circumstance rule of proposed § 53.4968–1(a)(4)(i) that another cash balance was reasonably necessary to cover its current administrative expenses and other normal and current disbursements directly connected with its exempt purposes. However, in recognition that commenters did not find the safe harbor useful, these final regulations instead provide a different safe harbor that is based on the specific expenses incurred by each educational institution. Specifically, these final regulations provide that a reasonable cash balance may be determined by any reasonable method, and that one such method would be to calculate an amount equal to three months of operating expenses allocable to program services, calculated by dividing annual functional expenses allocable to program services (2019 Form 990, Part IX, line 25, column (B), or the corresponding line provision of any successor Form 990) by four. Alternatively, a larger amount may be a reasonable cash balance for this purpose if, under the facts and circumstances, a larger amount is established to be necessary to cover administrative expenses and other normal disbursements directly connected with the institution's exempt activity.

f. Assets of Related Organizations

One commenter noted that section 4968(d) treats certain assets of related organizations with respect to an educational institution as assets of the educational institution, and that section 4968(b)(1)(D) requires the educational institution to determine whether, at the end of the preceding taxable year, the aggregate fair market value of its assets (other than those assets that are used directly in carrying out the institution's exempt purpose) is at least $500,000 per student of the institution. This commenter suggested that, in counting the assets of a related organization for this purpose, any asset of the related organization that is used directly in carrying out the educational institution's exempt purpose should be excluded from section 4968(b)(1)(D). In addition, the commenter asked how to apply the ''used directly in carrying out the institution's exempt purpose'' test in the case of a related organization with exempt purposes differing from those of the educational institution.

The Treasury Department and the IRS agree with these comments. Therefore, these final regulations provide that an asset of a related organization that is treated as an asset of the educational institution (in accordance with section 4968(d) and § 53.4968–3(c)) and is used directly in carrying out the educational institution's exempt purpose is considered used directly by the institution in carrying out its exempt purpose. These final regulations further provide that an asset of a related organization that is treated as an asset of the educational institution is considered to be used directly in carrying out the educational institution's exempt purpose if (1) the related organization is described in section 501(c)(3) and (2) the asset is being used directly in carrying out the related organization's exempt purpose.

For example, under this rule, if an educational institution controls (as described in part 7.b.ii of this Summary of Comments and Explanation of Revisions) a nonprofit nonstock organization that is a museum, then section 4968(d)(1)(B) would treat all of the museum's assets as assets of the educational institution, regardless of whether the assets are earmarked or restricted for the benefit of, or otherwise fairly attributable to, the educational institution, and even if they are specifically earmarked or restricted for another entity or for unrelated purposes or are otherwise not fairly attributable to the educational institution. However, when for purposes of section 4968(d)(1)(D) the educational institution values its assets (other than those used directly in carrying out the institution's exempt purpose) at the end of the preceding taxable year, the educational institution could exclude any museum asset, such as artwork, that is being used directly in carrying out the museum's exempt purpose, even if such use does not directly carry out the educational institution's exempt purpose. (The Treasury Department and the IRS note that the general rule found in § 53.4968–1(b)(5)(iii) that neither assets that are held for the production of income or for investment nor property (such as offices and equipment) used for the purpose of managing funds are considered used directly in carrying out an exempt purpose. Thus, a related organization whose exempt purpose is grantmaking generally will have few assets considered to be used directly in carrying out the educational institution's exempt purpose.)

g. Valuation of Assets Not Used Directly in Carrying Out an Institution's Exempt Purpose

The proposed regulations provided that, for purposes of valuing an educational institution's non-exempt use assets, the institution should use rules similar to the rules of section 4942(e) and § 53.4942(a)–2(c)(4), with two modifications. First, the phrase ''educational institution'' is substituted for ''private foundation'' or ''foundation'' every place they appear. Second, an institution will have to make such adjustments as are reasonable and necessary to obtain the fair market value of non-exempt use assets as of the last day of the valuation taxable year, rather than any other time(s) required by the section 4942 regulations. The proposed regulations also requested comments on valuing assets using the principles of section 4942, as modified by this special timing rule. No comments were received. Accordingly, the proposed rule is adopted without substantive changes.

6. Net Investment Income

For taxable years beginning after December 31, 2017, section 4968(a) imposes a 1.4 percent excise tax on the net investment income of an applicable educational institution (as defined in section 4968(c)), and on certain amounts of net investment income of certain related organizations, as described in section 4968(d) and § 53.4968–3. Section 4968(c) provides that net investment income is determined under rules similar to the rules of section 4940(c). Accordingly, the proposed regulations provided that an applicable educational institution generally must calculate net investment income under the rules of section 4940(c) and § 53.4940–1(c) through (f), with certain modifications.

Specifically, § 53.4968–1(b)(3) of the proposed regulations (1) substituted ''applicable educational institution'' for ''private foundation'' or ''foundation'' each place they appear; (2) did not apply the rule in § 53.4940–1(d)(3), because it is narrowly focused on section 302 stock redemptions by corporations that are disqualified persons and is not applicable to colleges and universities; (3) substituted ''December 31, 2017'' for ''December 31, 1969'' every place that it occurs to determine the basis of assets held on December 31, 2017, for purposes of determining gain upon the sale or exchange of an asset held on December 31, 2017 in calculating the excise tax; (4) applied the special basis rule to assets held in partnerships as of December 31, 2017, as well; and (5) allowed overall net losses from sales or other dispositions of property by one related organization or by the applicable educational institution to reduce (but not below zero) overall net gains from such sales or other dispositions by other related organizations or by the applicable educational institution.

Several commenters requested that the final regulations further tailor those rules to take into account differences between a private foundation subject to section 4940 and an educational institution, including differences in funding sources, use of funds, structure, governance, and oversight. In response, as discussed further in the following paragraphs of this part 6, these final regulations omit the use of a cross reference to the regulations under section 4940(c) to define net investment income for purposes of section 4968. Instead, these final regulations prescribe specific rules under section 4968 that are similar to the rules of section 4940(c) but that are more tailored to educational institutions.

In particular, following the regulations under section 4940(c), the final regulations provide, as further described in this part 6, that net investment income generally is the amount by which the sum of the gross investment income and the capital gain net income exceeds the allowable deductions. Also consistent with section 4940(c)(5) and § 53.4940–1(c)(2), net investment income is determined by applying section 103 (relating to interest on certain governmental obligations) and section 265 (relating to expenses and interest relating to tax-exempt income). Finally, consistent with section 4940(c)(1) and § 53.4940–1(c)(1), net investment income is determined under the principles of subtitle A of the Code except to the extent inconsistent with the Code or regulations.

a. Gross Investment Income

The proposed regulations noted that section 4968 does not expressly provide that the tax on net investment income is limited to net investment income derived from assets that are not used directly in carrying out an applicable educational institution's exempt purpose. This lack of a limitation is in contrast to the specific language in section 4968(b)(1)(D) that excludes assets used directly in carrying out an institution's exempt purpose in determining whether the educational institution is an applicable educational institution. Instead, section 4968(c) provides that net investment income is determined under rules similar to the rules of section 4940(c).

To implement this provision, the proposed regulations proposed to adopt by cross reference the rules provided in section 4940(c) and the regulations thereunder, including § 53.4940–1(d)(1), which specifies that ''gross investment income'' means the gross amounts of income from interest, dividends, rents, royalties (including overriding royalties), and capital gain net income received by a private foundation from all sources, but does not include such income to the extent included in computing the tax on unrelated business taxable income imposed by section 511. Under this definition, consistent with specific language in § 53.4940–1(d), interest, dividends, rents, and royalties derived from assets devoted to an educational institution's exempt activities would be includible in gross investment income. Therefore, for example, under the proposed regulations, interest received on a student loan would have been includible in income for purposes of section 4968.

The proposed regulations requested comments on whether specific types of income should be excluded from gross investment income under section 4968 because taxing those types of income would not achieve the congressional intent in enacting section 4968. Commenters recommended excluding interest from student and faculty loans, rental income from student and faculty housing, royalty income from exempt functions, income from programmatic activities, and income from endowment funds if the income is used as a tuition replacement fund.

These final regulations adopt most of these recommendations. These final regulations specify that, consistent with section 4940(c), gross investment income generally means the gross amounts of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not including any such income to the extent it is included in computing the tax imposed by section 511. Gross investment income also includes income from sources similar to those in the preceding sentence. In general, gross investment income includes the items of investment income described in § 1.512(b)–1(a).

However, in response to comments and consistent with the overall purpose of section 4968, these final regulations exclude from the definition of gross investment income (1) interest income from a student loan that was made by the applicable educational institution or a related organization to a student of the applicable educational institution in connection with the student's attendance at the institution; (2) rental income from the provision of housing by the applicable educational institution or a related organization to students of the applicable educational institution and from housing for faculty and staff if the housing is provided contingent on their roles as faculty or staff of the applicable educational institution; and (3) royalty income that is derived from patents, copyrights, and other intellectual property and intangible property to the extent those assets resulted from the work of student(s) or faculty member(s) in their capacities as such with the applicable educational institution. However, neither royalty income from trademarks on the institution's logo or name nor royalty income from intellectual property donated or sold to the institution is excluded from gross investment income under this rule).

i. Interest From Student Loans

The proposed regulations noted that the regulations under section 4940(c) specifically include student loan interest as gross investment income. However, recognizing that student loans provided directly by an applicable educational institution to its students can be seen as helping the applicable educational institution fulfill its mission of educating its students, and that, unlike private foundations, colleges and universities educate students and charge tuition as part of their primary exempt activities, the preamble to the proposed regulations asked whether student loans provided by an applicable educational institution to its students arguably can be viewed as a form of deferred tuition which will be paid when the student enters the workforce.

The preamble to the proposed regulations suggested distinguishing the interest on a student loan from investment interest by reference to the interest rate. If the interest is at a market (or higher) rate, it would be difficult to distinguish the interest on the student loan and interest on assets acquired for investment purposes. However, if the interest rate is set at a substantially below-market rate, the difference between the market interest rate and the interest rate on the student loan might be viewed as similar to a scholarship from the educational institution to the student. Under these circumstances, the remaining, below-market rate interest income might be considered distinguishable from income derived from assets acquired primarily for investment purposes. Finally, the preamble to the proposed regulations asked for comments on how a rule based on interest rates could be addressed to avoid administrative challenges for both the IRS and taxpayers in determining the relevant market-rate and an acceptable lower rate, and in adjusting to rate changes during the course of the loan.

Four commenters recommended excluding all interest income from loans to students from gross investment income, stating that loans made by colleges and universities to students are not offered with the intent of earning investment income for the institution, but are instead made to assist students who have gaps in funding and need financial assistance to complete their educations. Many of these student loans are need-based loans to low-income students who would not qualify for other programs or commercial loans. In addition, most of the student loans made by educational institutions are made on terms, taken as a whole, that are more favorable than similar commercial student loans. These better terms include lower interest rates, fixed interest rates, deferred or delayed repayment periods, low or no origination fees, relaxed eligibility requirements, and more flexible repayment plans than loans that are offered on the open market.

In response to these comments, these final regulations exclude from gross investment income interest income from a student loan that was made by the applicable educational institution (or a related organization of the institution) to a student of the institution in connection with the student's attendance at the institution.

While most of the student loans made by educational institutions (or their related organizations) may be made on terms, taken as a whole, that are more favorable than similar commercial student loans, many of those favorable terms are not centered on interest rates. For example, unlike commercial loans, no collateral or demonstrations regarding future income are required. Therefore, an exception based on whether terms are more favorable than commercial loans would be unduly burdensome to administer and these final regulations do not include such a requirement.

One commenter recommended extending 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. In most cases, this type of financing is an alternative to providing housing directly, the income or loss from which the commenter also recommended excluding. However, the commenter noted that there are nuances with respect to the types of faculty loans that may be provided by an educational institution that may warrant disparate treatment, and that an examination of all of the facts and circumstances (such as the resources of the borrowers, interest rate charged, availability of credit in the local area, and scope and extent of the program) would be necessary to determine whether a particular loan was effectively a substitute for bank financing and thus really an investment vehicle that should be considered to produce gross investment income.

These final regulations do not exclude interest on loans to faculty from gross investment income. Although loans to faculty might indirectly benefit students by attracting better faculty, so does paying faculty higher salaries. Some loans provide a substitute for bank financing for a faculty member to purchase a residence that then becomes an asset of the faculty member. All loans to faculty, even if on favorable terms as part of a compensation package in order to attract such faculty, are substantially different from loans to students which may be viewed as effectively representing deferred tuition. Furthermore, interest income received on loans to faculty is more difficult to distinguish from other interest income that is includible under section 4940(c), such as interest income at the applicable Federal rate on a loan to acquire a luxury home. While certain loans, such as one to allow faculty to secure appropriate housing that otherwise would not be attainable by faculty, might qualify as supporting the institution's exempt purposes, a similar loan in other circumstances might not. The difference would be heavily dependent upon interest rates, the local real estate market, and other facts and circumstances. Thus, in accord with the language in section 4968(c) that net investment income for section 4968 purposes should be similar to the rules of section 4940(c), the final regulations under section 4968 do not exclude interest income on loans other than loans to students in connection with their attendance at the educational institution.

ii. Rental Income From Student, Faculty, and Staff Housing

The proposed regulations also noted that colleges and universities offer various types of housing (such as dormitories or apartments) for use by students, non-students (for example, during the summer), and faculty. The preamble to the proposed regulations requested comments on the differences, if any, among the housing arrangements, whether any of the arrangements include the signing of leases, the various amounts charged by a college or university related to provision of housing and meals, and particular factors that distinguish room and board payments from students living in a dormitory from rental income that institutions receive.

Five commenters recommended excluding income from student housing from gross investment income. These commenters stated that student housing is provided by educational institutions to their students for the purpose of furthering the students' education, rather than to create an investment return to the institution. On-campus housing provides a sense of community and creates non-classroom opportunities for students to engage with individuals with a similar academic focus as well as those with diverse perspectives and backgrounds, which promotes informal learning and development of social skills. It also facilitates studying and attending classes on campus, provides students with the full breadth of campus security services, and provides convenient access to campus dining halls. Many educational institutions require students to live in on-campus housing for one or more years. Further, several factors distinguish student housing from other rental properties that institutions may own. For example, typical residential rental agreements provide secure and exclusive access to a specific property for the tenant's use, and the tenant has the right to continuous occupancy and use of the specified space over the term of the lease. In contrast, students sign a contract for housing, but typically do not sign leases. They are assigned a space, within a room often shared by at least one other individual, frequently a stranger. Residence halls and student apartments or houses are typically not available year-round, but only during academic terms. For example, that housing might close over certain holidays and during breaks between semesters. Housing space normally is contingent on enrollment at the educational institution, and students that withdraw from the institution must vacate their rooms. Students are subject to specific housing rules and codes of conduct while in student housing, often including a prohibition on cooking. Residence halls also typically include the presence of a resident advisor, who is available 24 hours a day and may monitor the students' behavior. Guest access to student residences often is monitored or restricted.

The Treasury Department and the IRS agree that income received from the housing of current students of an educational institution is distinguishable from other types of traditional rental income, and these final regulations exclude such income from gross investment income, whether the housing is provided to the educational institution's students by the institution or a related organization of the institution.

Two commenters further recommended that rental income from faculty and staff housing also should be excluded from net investment income, stating that faculty and staff housing is a critical strategic resource used by universities to recruit and retain exceptional personnel. The commenters note that the provision of faculty and staff housing allows faculty and staff to live closer to campus, which not only is a convenience for such individuals but also allows them to more fully participate in the campus experience, contributing to a vibrant and dynamic residential and academic campus. Two commenters mentioned that housing rental prices generally are not set based on market rates but on actual cost, and many institutions operate housing at a loss, although it would be administratively burdensome to determine a theoretical market rate for each housing unit as well as to break out the income and expenses related to each housing unit.

The Treasury Department and the IRS agree that rental income from housing provided to an institution's faculty and staff can be distinguished from other types of rental income if the housing is provided contingent on their capacities as faculty or staff (for example, if the rental agreement contains a provision that the person must be currently employed as faculty or staff of the applicable educational institution). Thus, these final regulations exclude such income from gross investment income, whether the housing is provided to the educational institution's faculty or staff by the institution or a related organization of the institution. These final regulations do not, however, exclude rental income from other persons, or from former faculty or staff.

Two commenters recommended that rental income from dormitories and other student housing that is made available to students and nonstudents alike for educational programs and camps open to the public that are outside of the institution's academic year, particularly during the summer months, also be excluded from gross investment income. These final regulations do not adopt this suggestion. Such income may, depending on the circumstances, constitute unrelated business taxable income and be excluded from section 4968 for that reason. For example, if the income is from leasing to third parties that conduct summer camps and programs at the institution and the institution provides substantial personal services with respect to the rented facilities, it likely is unrelated business taxable income. Furthermore, the leasing of student housing to third parties for the operation of camps and programs run by third parties is not materially distinguishable from typical rental income. Also, if the summer camp or program is not operated by the educational institution, then the educational institution does not control who is staying in the housing and the housing is not necessarily provided for the benefit of the institution's current students or to contribute directly to achieving its educational purpose. However, the Treasury Department and IRS note that rental income from dormitories and other housing provided to current students that extends through the summer months (such as graduate student housing) would meet the exception for housing provided to students and would be excluded from gross investment income.

iii. Royalty Income From Exempt Functions

Two commenters asked that royalty income derived from educational and research activities conducted by an applicable educational institution be excluded from the institution's gross investment income. The commenters stated that universities conduct research as part of the pursuit of knowledge by faculty and students rather than for the purpose of earning income. Both commenters stated that royalties derived from research that is directly conducted by students, faculty, and researchers is distinguishable from the royalty income earned by most private foundations because private foundations receiving royalty income ''normally'' have passive holdings in intellectual property that was not developed by the private foundations. (One commenter clarified that royalty income earned from ''passive investments'' was not intended to be included in this proposed exception for purposes of section 4968.)

Both commenters represented that it would be a significant administrative burden to capture all expenses and costs allocable to such royalty income, including expenses incurred in applying for, obtaining, and defending a patent and in developing and negotiating license agreements during the life of the patent, and both commenters estimated that such annual expenses would equal or exceed the annual gross investment income from such royalties.

The Treasury Department and the IRS agree that applicable educational institutions produce intellectual property as part of the pursuit of knowledge by faculty and students. These activities generally are not engaged in for profit and they are not passive investment activity. Instead, these activities are integral to an educational institution's exempt purposes. As a result, these final regulations exclude certain royalties generated by such educational and research activities from gross investment income for purposes of section 4968.

Specifically, these final regulations exclude from gross income royalty income that is derived from patents, copyrights, and other intellectual property and intangible property to the extent those assets resulted from the work of student(s) or faculty member(s) in their capacities as such with the applicable educational institution. However, neither royalty income from trademarks on the institution's logo or name nor royalty income from intellectual property donated or sold to the institution is excluded from gross investment income under this rule.

iv. Income From Programmatic Activities

Two commenters recommended excluding any income derived by an educational institution from the conduct of its core educational and research activities (that is, programmatic activities) from gross investment income. The commenters stated that taxing income that is derived directly from a college or university's exempt purpose is inconsistent with the intent of section 4968, which is intended to tax investment income. However, one commenter did not include any specific examples of types of income that would be gross investment income derived from the conduct of an applicable educational institution's core educational and research activities, and the other commenter gave as examples tuition, museum or gym admission fees, and income from a related business, such as a campus bookstore—none of which would be included in the definition of gross investment income under the proposed regulations.

The Treasury Department and the IRS note that private foundations may earn gross investment income in the conduct of their exempt activities, but that such income is explicitly considered gross investment income by section 4940(c) and § 53.4940–1(d). The preamble to the proposed regulations specifically asked commenters, when commenting on whether specific types of income should be excluded from gross investment income under section 4968 because taxing those types of income would not achieve the congressional intent in enacting section 4968, to state specifically how any such proposed exclusion would still be ''similar to'' the rules of section 4940(c) and the specific characteristics of each type of such income that would warrant deviating from the rules provided in section 4940 and the regulations thereunder. Furthermore, it is unclear what types of income, other than student loan interest, rental income from certain housing, and certain royalty income, otherwise would be gross investment income earned in the conduct of an applicable educational institution's exempt activities. Accordingly, other than the exclusions listed in part 6.a.i., ii., and iii., these final regulations do not include an exclusion from gross investment income for income earned in the conduct of an applicable educational institution's exempt activities.

v. Excluding Income on Endowment Funds if the Income Is Used as a Tuition Replacement Fund

One commenter recommended excluding income from endowment funds from gross investment income if the income is used as a tuition replacement fund for all of the applicable educational institution's students.

Section 4968(c) provides that, for purposes of section 4968, net investment income is determined under rules similar to the rules of section 4940(c). Neither section 4968(c) nor 4940(c) provide an exclusion from net investment income for the income from an institution's endowment fund, regardless of what the income is ultimately used for. Thus, these final regulations do not exclude the income from an institution's endowment fund (however defined) from gross investment income, even if the income from the endowment fund is used as a tuition replacement fund.

b. Deductions

i. In General

As stated in part 6.a of this Summary of Comments and Explanation of Revisions, the proposed regulations provided that an institution generally must calculate net investment income under rules similar to the rules of section 4940(c). The proposed regulations proposed to adopt this approach, incorporating by cross reference the provisions of § 53.4940–1(c) through (f), with certain modifications. These final regulations delete the use of a cross reference to the regulations under section 4940(c) and instead prescribe specific rules that are similar to the rules of section 4940.

Thus, consistent with section 4940(c) and § 53.4940–1(e)(1)(i), § 53.4968–2(c)(1)(i) of these final regulations explicitly states that there is allowed as a deduction from gross investment income all the ordinary and necessary expenses, including operating expenses, paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications described in part 6.b.ii of this Summary of Comments and Explanation of Revisions.

An applicable educational institution's operating expenses related to its gross investment income may include compensation of officers, other salaries and wages of employees, outside professional fees, interest, and rental payments and taxes upon property used in the applicable educational institution's operations other than in its exempt activities. An applicable educational institution's operating expenses that are incurred both for investment and exempt purposes, such as salaries for officers or other employees, must be allocated between the investment and exempt activities of that institution on some reasonable basis. Similarly, consistent with § 53.4940–1(e)(1)(iii), in cases in which only a portion of property produces, or is held for the production of, income subject to the section 4968 excise tax, and the remainder of the property is used for other purposes, the expenses are apportioned between the taxable and other uses. Furthermore, to the extent an applicable educational institution's expenses are taken into account in computing the tax imposed by section 511, they are not deductible for purposes of computing the tax imposed by section 4968.

Consistent with § 53.4940–1(e)(1)(iii), no amount is allowable as a deduction to the extent it is paid or incurred for purposes other than the production or collection of gross investment income as determined for section 4968 purposes, or for the management, conservation, or maintenance of property held for the production of such income. Thus, for example, the charitable deduction prescribed under section 170 or 642(c), the net operating loss deduction prescribed under section 172, and certain special deductions for corporations under sections 241 through 250 prescribed under part VIII of subchapter B of chapter 1 of the Code (part VIII of subchapter B) are not allowable as a deduction in determining section 4968 net investment income. Taxes imposed under section 4968 are not paid or incurred for the production or collection of gross investment income.

ii. Modifications

Consistent with section 4940(c) and § 53.4940–1(e)(2), these final regulations provide that the following modifications must be made in determining deductions otherwise allowable under these final regulations, as explained in part 6.b.i of this Summary of Comments and Explanation of Revisions.

First, consistent with section 4940(c)(3)(B)(i) and § 53.4940–1(e)(2)(i), a depreciation deduction is allowed, but only on the basis of the straight line method provided in section 168(b)(3) and without regard to paragraphs (1) and (2) of section 168(b).

Second, consistent with section 4940(c)(3)(B)(ii) and § 53.4940–1(e)(2)(ii), a depletion deduction is allowed, but such deduction is determined without regard to sections 613 and 613A, relating to percentage depletion.

Third, consistent with § 53.4940–1(e)(2)(iii), basis to be used for purposes of calculating the deduction allowed for depreciation or depletion is the basis determined under the rules of part II of subchapter O of chapter 1 of the Code (part II of subchapter O), subject to the previously described modifications for calculating depreciation and depletion, and without regard to § 53.4968–2(d)(2) (relating to the basis for determining gain for property held on December 31, 2017, and continuously thereafter to the date of disposition, discussed in part 6.c of this Summary of Comments and Explanation of Revisions) or section 362(c) (relating to certain contributions to capital). Thus, an applicable educational institution must reduce the cost or other substituted or transferred basis by an amount equal to the straight-line depreciation or cost depletion, without regard to whether the institution deducted such depreciation or depletion during the period prior to its first taxable year beginning after December 31, 2017. However, in cases in which an applicable educational institution has previously taken depreciation or depletion deductions in excess of the amount which would have been taken had the straight line or cost method been employed, such excess depreciation or depletion also is taken into account to reduce basis. If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to a donee applicable educational institution, then the institution's original basis in such property is determined under the rules of § 1.1015–1(a)(3).

One commenter requested that the step-up rule for calculating gain upon the disposition of assets held on December 31, 2017 (discussed later in this Summary of Comments and Explanation of Revisions) also apply for purposes of calculating depreciation and depletion, stating that educational institutions, which are more likely than private foundations to hold on to depreciable assets, otherwise 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 the current fair market value basis. These final regulations do not adopt such a rule because it would be contrary to section 4940(c) and applicable educational institutions do not seem to be distinguishable from private foundations on this issue.

Fourth, consistent with § 53.4940–1(e)(2)(iv), the deduction for expenses paid or incurred in any taxable year for the production of gross investment income, as determined for section 4968 purposes, earned as an incident to a charitable function can be no greater than the income earned from such function which is includible as gross investment income for such year. For example, where rental income is incidentally realized in a year from historic buildings held open to the public, deductions for amounts paid or incurred in that year for the production of such income is limited to the amount of rental income includible as gross investment income for the year.

c. Capital Gains and Losses

The proposed regulations contained three special rules relating to capital gains and losses. First, consistent with Notice 2018–55, the proposed regulations substituted ''December 31, 2017'' for ''December 31, 1969'' each place it appears in § 53.4940–1(c)–(f), to provide a step-up in basis (if any) for purposes of calculating gain upon the sale or other disposition of assets held on December 31, 2017, and continuously thereafter to the date of disposition.

Second, in response to a comment received in response to Notice 2018–55, the proposed regulations provided that, if an applicable educational institution held an interest in a partnership (including through one or more tiers of partnerships) on December 31, 2017, and continuously thereafter, and the partnership held assets on December 31, 2017, and continuously thereafter to the date of disposition, the partnership's basis in its assets with respect to the applicable educational institution for purposes of determining the applicable educational institution's share of gain upon sale or other disposition of the assets by the partnership will not be less than the fair market value of such asset on December 31, 2017, plus or minus all adjustments as provided under § 53.4940–1(f)(2)(i) after December 31, 2017, and before the date of disposition. The proposed regulations stated that, to avail itself of this special partnership basis rule, an institution must obtain documentation from the partnership to substantiate the basis used.

Third, the proposed regulations provided that, for purposes of § 53.4940–1(f), overall net losses from sales or other dispositions of property by one related organization (or by the applicable educational institution) reduce (but not below zero) overall net gains from such sales or other dispositions by other related organizations (or by the applicable educational institution).

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

Commenters addressed several aspects of the proposed rules for capital gain net income, including the taxation of capital gain net income on the sale of exempt use property; capital gain net income on the sale of donated property; the step-up rule for assets held in a partnership on December 31, 2017; and whether capital loss carryovers should be allowed.

In response to these public comments and as discussed in in more detail in part 6.c.i through iii of this Summary of Comments and Explanation of Revisions, these final regulations provide that (1) capital gain net income from the sale or exchange of property used by an institution for its exempt purpose is disregarded for the portion of the property that is used for the exempt purpose; (2) any appreciation in the value of donated property that occurred prior to the date of its donation to the institution is disregarded; and (3) capital loss carryovers are allowed but not capital loss carrybacks.

Consistent with section 4940(c)(4)(A) and (D) and the proposed regulations, these final regulations also provide that in determining capital gain net income for purposes of the tax imposed by section 4968, no gain or loss from the sale or other disposition of property is taken into account to the extent that such gain or loss is taken into account for purposes of computing the tax imposed by section 511.

i. Capital Gain Net Income on Sale of Exempt Use Property

Two commenters recommended excluding from capital gain net income gain from the sale of exempt use property. One of the commenters stated that exempt use property is excluded from section 4968(b)(1)(D)'s calculation for determining the applicability of section 4968, and that it would thus be inconsistent to tax the educational institution on the sale of such property. This commenter also stated that taxing income that is derived directly from a college or university's exempt purpose assets is inconsistent with the intent of section 4968, which is aimed at investment income. The other commenter said that the proposed regulation's reference to § 53.4940–1(f)(1) suggested such a result, but asked that the final regulations clarify this reading.

Section 4940(c)(4)(A) was amended in 2006 [5] to provide that ''there shall not be taken into account any gain or loss from the sale or other disposition of property to the extent that such gain or loss is taken into account for purposes of computing the tax imposed by section 511.'' By implication, section 4940(c)(4)(A) thus provides that all gain or loss from the sale or other disposition of any and all property, other than any gain or loss that is taken into account for purposes of computing the tax imposed by section 511, is taken into account for purposes of section 4940(c).[6]

Section 4968(c) provides that net investment income for purposes of section 4968 is determined under rules similar to the rules of section 4940(c). Section 4940(c) was specifically amended in 2006 and 2007 to provide that capital gain net income is no longer limited only to property that was held for investment purposes and, instead, extends to all property held by a private foundation, including property used for exempt purposes. The only exceptions to this general rule are for ''any gain or loss from the sale or other disposition of property to the extent that such gain or loss is taken into account for purposes of computing the tax imposed by section 511'' and for certain like-kind exchange-type dispositions. *See* Section 4940(c)(4)(A) and (D).

However, educational institutions as a general matter own more tangible property and more different types of tangible property used in the performance of their exempt purposes than a typical private foundation. Further, constantly changing and growing student populations, as well as new developments and innovations and needs in education and research, requires educational institutions to continually reevaluate their needs for property and possibly to replace or upgrade certain property. This process is likely to result in the need to sell assets in order to best serve the educational institution's exempt purposes. For instance, property such as residential and educational buildings, libraries, laboratories, and information technology assets often are sold as needs change. Income from such sales generally is reinvested in acquiring upgrades or replacements for that property, and therefore is integral to the performance of the exempt function of the institution, rather than for an investment purpose. Accordingly, these final regulations exclude from capital gain net income the gain from the sale or exchange of exempt use property for the portion of the property that is used for the exempt purpose.

ii. Capital Gain Net Income From the Sale of Donated Property

Five commenters responded to the proposed regulations' request for comments on the calculation of capital gain net income from the sale of donated property, all recommending that any appreciation that occurred prior to an institution's receipt of the donated property be excluded from such gain. The commenters stated that the purpose of section 4968 is to tax institutions on their own net investment income, not to tax donations, and that it would thus be inequitable to tax applicable educational institutions on the appreciation in value that occurred before the donee institution received the donation of a capital asset. Commenters also stated that donated property normally is not actually retained and held as an investment; instead, applicable educational institutions typically sell donated property as soon as possible. Thus, the gain upon sale of donated property often is attributable to the appreciation that occurred before the institution received the property.

[5] The amendments to section 4940(c)(4)(A) were made by the Pension Protection Act of 2006, Public Law 109–280, and the Tax Technical Corrections Act of 2007, Public Law 110–172 (which conformed the language of section 4940(c)(4)(A) to the 2006 JCT Technical explanation).

[6] According to the JCT Technical explanation (JCX–38–06), the reason for amending section 4940(d)(4)(A) in 2006 and 2007 was that section 4940(c) does not provide for the blanket exclusion of gain or loss from the sale or other disposition of assets used for exempt purposes that was provided in the section 4940 regulations. Section 53.4940–1(f)(1)), which has *not* been updated to reflect the amendments made in 2006 and 2007, provides that ''there shall be taken into account *only* capital gains and losses from the sale or other disposition of property held by a private foundation for investment purposes'' and ''*gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded.*'' (Emphasis added.) Although the section 4940 regulations, which have not been revised since 1992, have not been revised to reflect the changes to section 4940(c)(4)(A) made in 2006 and 2007, the current statute is clear that capital gain net income includes (and is intended to include) gain from property used by a private foundation for exempt purposes.

Three commenters noted that, although a private foundation must use the donor's transferred basis in computing any gain from the sale of donated property, a private foundation has the option of making gifts of appreciated property to section 501(c)(3) public charities by funding their grants in kind, resulting in no excise or income tax being imposed on either organization when the property eventually is sold. These commenters stated that it would be difficult for applicable educational institutions to take advantage of this strategy. One commenter opined that private foundations generally are able to time their sales to offset losses more efficiently than educational institutions can. The commenter asserted that the substantially higher operational expenses of an educational institution sometimes require that institution to sell a donated asset upon receipt. The commenter also opined that, because these donated assets are not retained for investment purposes, they do not produce net investment income.

All commenters stated that the requirement to obtain a donor's basis information will be administratively burdensome. Unlike private foundations, which typically receive donations from a small number of known donors, applicable educational institutions receive a large number of donations from a wide variety of donors. In many cases, institutions will be unable to determine (or verify) the transferred basis under section 1015 of the donated property. Further, the commenters stated, requesting donors to provide their basis information could negatively affect an applicable educational institution's relationships with donors.

One commenter stated that applicable educational institutions could work around this issue by encouraging donors to donate any appreciated property to a donor advised fund that then could sell the property and contribute the cash proceeds to the institution.

The Treasury Department and the IRS agree that the differences between applicable educational institutions and private foundations with respect to donations of property justify a rule under section 4968 that is different from the treatment found in section 4940(c) for the treatment of the capital gain net income of property donated to a private foundation. In addition, such a rule will increase administrability for both taxpayers and the IRS by removing the requirement to determine the donor's basis of the donated property. Furthermore, it will avoid placing different applicable educational institutions receiving stock of equal value but with different bases in different positions with regard to the computation of their respective net investment income merely from receiving the donated property.

Accordingly, these final regulations provide that any appreciation in the value of donated property that occurred prior to the date of donation to the applicable educational institution is disregarded in calculating gain for purposes of section 4968. This special rule does not, however, change the transferred basis of the donated property; thus, an applicable educational institution must obtain the transferred basis of donated property under section 1015 for purposes of claiming a loss upon its sale or other disposition or for purposes of calculating depreciation or depletion.

One commenter requested that the final regulations recognize that a college or university that disposes of contributed property at the first reasonable opportunity is not holding such property for investment purposes and, accordingly, exclude all of the proceeds from the sale of such contributed property from capital gain. The same commenter suggested a safe harbor under which property disposed of within 30 days of receipt would be treated as having been disposed of at the first reasonable opportunity. These final regulations do not adopt either suggestion, because there is no analog in section 4940(c) or in any other provision of the Code. Furthermore, any cut off would be arbitrary and there is no justification for why one day versus another day should not result in the recognition of gain. While these final regulations disregard any appreciation that occurred prior to an institution's receipt of the donated property, appreciation that occurs after an institution's receipt of the donated property is included in net investment income. For consistency with the rules applicable to charitable deductions, the date of donation is determined under the timing rules of § 1.170A–1(b) and the value on the date of donation is determined under the valuation rules of § 1.170A–1.

iii. Capital Loss Carryovers

One commenter requested that capital loss carryovers be allowed. This commenter represented that a private grant-making foundation, to the extent it has satisfied its minimum distribution requirements, can easily curtail its spending (and the realization of capital gains while converting investment assets to cash) by issuing fewer or smaller grant awards to manage its section 4940 tax liability. The commenter contrasted such a foundation with an educational institution that typically has a large operating budget with significant nondiscretionary expenses related to employees and infrastructure and must find ways to meet its ongoing cash needs, which may involve selling investments at particular times that may not be advantageous from an investment or tax perspective.

Although section 4940(c) explicitly allows losses from sales or other dispositions of property only to the extent of gains from such sales or other dispositions, and does not allow capital loss carryovers or carrybacks, the commenter represented that, given the differences between private foundations and educational institutions, the allowance of capital loss carryovers is necessary to achieve outcomes for educational institutions under section 4968 that are ''similar to'' the outcomes for private foundations under section 4940(c).

The Treasury Department and the IRS acknowledge that there are various and notable differences between private foundations subject to section 4940(c) and educational institutions in their missions, functions, and operating expenses. Therefore, based on a general understanding, as further informed by commenters, of the way educational institutions manage both their substantial, nondiscretionary operating expenses in furthering their exempt purposes and their investment activities, these final regulations allow the use of capital loss carryovers.

Accordingly, these final regulations adopt the rule in the proposed regulations that overall net losses from sales or other dispositions of property by one related organization (or by the applicable educational institution) reduce (but not below zero) overall net gains from such sales or other dispositions by other related organizations (or by the applicable educational institution). In addition, these final regulations adopt the rule in the proposed regulations that, should overall net losses from sales or other dispositions of property exceed gains from sales or other dispositions of such property during the same taxable year, such excess may not be deducted from gross investment income in any taxable year, nor may such excess be used to reduce gains in prior taxable years. However, the final regulations provide that capital loss carryovers are allowed and may be deducted from capital gains in a future year.

d. Basis

These final regulations provide rules for determining basis or a substitute for basis (in the context of section 4968) for purposes of determining (1) gain from the sale or other disposition of property other than a partnership interest; (2) a distributive share of gain from the sale or other disposition of an asset held in a partnership; (3) gain on the sale of a partnership interest; and (4) loss.

i. Basis for Purposes of Determining Gain From the Sale or Other Disposition of Property Other Than a Partnership Interest

Consistent with the proposed regulations and with section 4940(c), these final regulations provide that the basis for purposes of determining gain from the sale or other disposition of property (other than a partnership interest) is generally the greater of (1) fair market value of the property on December 31, 2017, plus or minus all adjustments after December 31, 2017, and before the date of its disposition under the rules of part II of subchapter O, provided that the property was held by the applicable educational institution on December 31, 2017, and continuously thereafter to the date of its disposition, or (2) basis as determined under the rules of part II of subchapter O, subject to the three modifications described at the beginning of part 6.b.ii. of this Summary of Comments and Explanation of Revisions (referring to the modifications relating to deductions against gross investment income). See parts 6.d.ii. and 6.e. of this Summary of Comments and Explanation of Revisions for special rules regarding determining a distributive share of capital gain from the sale or other disposition of an asset held in a partnership and on the sale of a partnership interest.

ii. Basis for Purposes of Determining a Partner's Distributive Share of Gain From the Sale or Other Disposition of an Asset Held in a Partnership and Gain From the Sale or Other Disposition of a Partnership Interest

The proposed regulations provided that if an applicable educational institution held an interest in a partnership (including through one or more tiers of partnerships) on December 31, 2017, and continuously thereafter, and the partnership held an asset on December 31, 2017, and continuously thereafter to the date of disposition by the partnership, the partnership's basis in such asset (for purposes of determining the applicable educational institution's share of gain upon sale or other disposition of that asset) is not less than the fair market value of such asset on December 31, 2017, plus or minus all adjustments as provided under § 53.4940–1(f)(2)(i) after December 31, 2017, and before the date of disposition.

Four commenters addressed the requirement in the proposed regulations that, for purposes of applying this rule, an applicable educational institution must obtain documentation from the partnership to substantiate the basis used. The commenters stated that, while an applicable educational institution can obtain documentation to establish its basis in its partnership interest (outside basis) as of December 31, 2017, obtaining documentation to establish its share of the basis of each partnership asset (inside basis) would be extremely burdensome and that an asset-by-asset determination of gain might, therefore, not be possible.

The commenters stated that applicable educational institutions often hold interests in hundreds of partnerships, many with numerous investors, that may involve multiple tiers of flow-through entities, and that applicable educational institutions generally are passive investors in these partnerships. Commenters stated that it would be very difficult, if not impossible, for applicable educational institutions to obtain the required basis documentation from all the partnerships, especially because there is no requirement for partnerships to provide such documentation and because reporting from partnerships generally is done on an aggregate basis and not on an asset-by-asset basis. Commenters added that many partnerships may not even be aware that their partners include an applicable educational institution.

The commenters recommended that the substantiation rule in the proposed regulations be removed and that an applicable educational institution instead be allowed to determine the amount of built-in gain in the applicable educational institution's share of partnership assets using any reasonable method. Two commenters recommended a method, described in part 6.e. of this Summary of Comments and Explanation of Revisions, that would use the difference between fair market value and outside basis of a partnership interest on December 31, 2017, to approximate the amount of cumulative built-in gain in an applicable educational institution's share of partnership assets on such date.

The Treasury Department and the IRS recognize the problem described by commenters with regard to the proposed substantiation rule and agree that another approach for determining the amount of built-in gain in partnership assets solely for purposes of applying section 4968 would be appropriate in alleviating the problem. Accordingly, these final regulations remove the proposed substantiation rule and eliminate the need to determine a step-up in a partner's share of bases in partnership assets for purposes of section 4968. As a result, the bases of partnership assets on December 31, 2017, are not stepped up for purposes of section 4968. Rather, for purposes of determining an applicable educational institution's share of gain upon the sale or other disposition of an asset held in a partnership, these final regulations provide that the applicable educational institution's basis in each partnership asset generally is determined under the rules of subchapter K of chapter 1 of the Code (subchapter K), but also provide a method, more fully described in part 6.e. of this Summary of Comments and Explanation of Revisions, which generally enables an applicable educational institution to offset its distributive share of capital gain net income from partnership asset dispositions by a portion of the built-in gain in the applicable educational institution's interest in the partnership as of December 31, 2017.

These final regulations provide a similar rule for determining an applicable educational institution's gain upon the sale or other disposition of all or a portion of a partnership interest.

iii. Basis for Purposes of Calculating Loss

Consistent with the proposed regulations and with section 4940(c), for purposes of determining loss from the sale or other disposition of property, basis is determined under the rules of part II of subchapter O, subject to the modifications of part 6.b.ii. of this Summary of Comments and Explanation of Revisions (referring to the modifications relating to depreciation and depletion deductions against gross investment income). For purposes of determining loss from the sale or other disposition of a partnership interest, basis is determined under the rules of subchapter K.

e. Special Rules Regarding Partnership Interests and Partnership Assets

As described in part 6.d.ii. of this Summary of Comments and Explanation of Revisions, commenters stated that it would be very difficult, if not impossible, for institutions to obtain the basis documentation necessary to apply the partnership asset basis step-up rule provided in the proposed regulations.

As an alternative, two commenters recommended a method that would use the difference between the fair market value and outside basis of an applicable educational institution's partnership interest on December 31, 2017, to approximate the difference between the fair market value and inside basis of, and thus the amount of built-in gain in, the applicable educational institution's share of partnership assets on such date. The commenters stated that the difference between fair market value and tax basis of an applicable educational institution's partnership interest on December 31, 2017, generally should reflect the amount of the applicable educational institution's built-in gain in its share of the partnership's assets on such date, and that, because educational institutions should know the fair market values and tax bases of their partnership interests on December 31, 2017, they should be able to calculate the built-in gain in their partnership interests as of December 31, 2017.

Specifically, the commenters recommended that an applicable educational institution should be allowed to offset the distributive share of partnership capital gain net income after December 31, 2017, allocated by a partnership by the amount of the built-in gain the applicable educational institution had in its partnership interest, determined as of December 31, 2017. Under the commenters' approach, an applicable educational institution would determine its built-in gain in a partnership interest as of December 31, 2017, and then not report any capital gain allocated from that partnership after December 31, 2017, as being subject to section 4968 until the cumulative amount of such excluded gain equals the amount of built-in gain in the interest. The commenters recommended that this rule be applied on a partnership-by-partnership basis and be available to reduce the amount of an applicable educational institution's capital gain net income on a first-recognized basis.

For the reasons described in part d.ii of this Summary of Comments and Explanation of Revisions, these final regulations adopt an approach that is similar to the approach recommended by the commenters in regard to determining an applicable educational institution's distributive share of gain allocated from a partnership (partnership asset disposition rule), as well as adding a partnership interest disposition rule. These final regulations provide that, for each partnership interest an applicable educational institution held on December 31, 2017, the applicable educational institution may determine an unadjusted step-up amount that is equal to the excess, if any, of the fair market value of such partnership interest on December 31, 2017, over the adjusted basis of such partnership interest on December 31, 2017. Then, for purposes of computing net investment income for taxable years beginning after December 31, 2017, an applicable educational institution will reduce its distributive share of capital gain net income from such partnership by the least of (1) the applicable educational institution's share of applicable capital gain from such partnership (that is, both short-term and long-term capital gain for the first taxable year after December 31, 2017, but only long-term capital gains and losses for subsequent years because short-term capital gains and losses in such years could not have been included in the amount of outside built-in gain as of December 31, 2017); (2) one-third of the applicable educational institution's unadjusted step-up for such partnership; or (3) the applicable educational institution's adjusted step-up for such partnership (which, in general, is its unadjusted step-up reduced by any capital gain that was previously excluded pursuant to the partnership asset disposition rule or the partnership interest disposition rule described in this paragraph).

These final regulations do not apply the capital gain net income reduction rule on a first-recognized basis, as recommended by the commenters. The excess of fair market value over tax basis of a partnership interest on December 31, 2017, may reflect built-in gain in partnership assets that would not be included in net investment income for purposes of section 4968—for example, ordinary income property. Additionally, application of the rule to offset all first-recognized capital gain net income in determining the educational institution's net investment income could provide a benefit to applicable educational institutions that would be inconsistent with the purpose of section 4968 by permitting a reduction in capital gain net income subject to section 4968 that is attributable to a partnership asset both acquired, and disposed of, after December 31, 2017. Accordingly, these final regulations adopt a middle ground position that spreads the exclusion without burdensome asset-by-asset matching by providing that the maximum amount of an applicable educational institution's capital gain net income from a partnership that may be excluded in any given year cannot exceed one-third of the applicable educational institution's unadjusted step-up for such partnership.

Commenters did not provide a recommendation for coordinating the partnership asset disposition rule with a partnership interest disposition rule. However, consistent with permitting an applicable educational institution to offset its distributive share of capital gain net income from partnership asset dispositions, these final regulations also provide a capital gain net income reduction rule in the context of a sale or other disposition of all or a portion of a partnership interest. These final regulations provide that, for purposes of computing net investment income, an applicable educational institution reduces the amount of its capital gain net income upon the sale or other disposition of all or a portion of a partnership interest by an amount that bears the same relation to the applicable educational institution's adjusted step-up for such partnership as the fair market value of the transferred portion of the interest bears to the fair market value of the applicable educational institution's entire interest in such partnership before the sale or other disposition.

7. Related Organizations

Section 4968(d)(1) provides, in part, that the assets and net investment income of any related organization with respect to an educational institution are to be treated as assets and net investment income, respectively, of the educational institution. To determine which assets of a related organization are included by section 4968(b)(1)(D) for a particular year, an educational institution determines which organizations are related organizations, as defined in section 4968(d)(2), as of the end of the educational institution's preceding taxable year, and values the relevant assets on that date. To determine the amount of net investment income of a related organization that is included by the applicable educational institution in calculating the tax imposed by section 4968(a) for a particular taxable year, an applicable educational institution determines which organizations are related organizations, as defined in section 4968(d)(2), as of the end of that taxable year of the applicable educational institution and includes the net investment income from each related organization's tax year that ends with or within that same taxable year of the applicable educational institution. If an organization becomes a related organization within the applicable educational institution's taxable year and remains a related organization as of the end of the taxable year, then the applicable educational institution includes the organization's net investment income for the portion of the year that it was a related organization, using any reasonable method.

The statute provides two exceptions to the rules for including assets and net investment income of a related organization as assets and net investment income of the educational institution: (1) No such amount is to be taken into account with respect to more than one educational institution, and (2) unless the related organization is controlled by the institution or is described in section 509(a)(3) (relating to supporting organizations) with respect to the institution for the taxable year, assets and net investment income that are not intended or available for the use or benefit of the institution are not to be taken into account by it. Section 53.4968–3 of these final regulations provides definitions and special rules relating to related organizations.

a. Definition of Related Organization

Under section 4968(d)(2), the term ''related organization'' means, with respect to an educational institution, any organization that (1) controls the educational institution; (2) is controlled by the educational institution; (3) is controlled by one or more persons that also control the educational institution; (4) is a supported organization (as defined in section 509(f)(3)) with respect to the educational institution during the taxable year; or (5) is a supporting organization (as described in section 509(a)(3)) with respect to the educational institution during the taxable year.

The first three categories of related organizations require control of an organization, but the statute does not define the term ''control.'' Furthermore, whether the educational institution is the controlling or controlled entity matters because if the related organization controls the educational institution, or is controlled by one or more persons that also control the educational institution, then assets and net investment income of the related organization that are not intended or available for the use or benefit of the educational institution are not taken into account. In contrast, if a related organization is controlled by an educational institution, then all the assets and net investment income of the related organization are taken into account by the educational institution, with the exception that the same assets are not taken into account by more than one educational institution.

The proposed regulations provided a definition of control derived from section 512(b)(13)(D) and the regulations thereunder, consistent with the definition of control contained in Notice 2019–09, ''Interim Guidance Under Section 4960'' (2019–04 I.R.B. 403), and requested comments on whether there were any circumstances in which this proposed definition of control should be modified in the context of section 4968.

Specifically, the proposed regulations defined control as: (1) In the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of the corporation; (2) in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership; (3) in the case of a trust with beneficial interests, ownership of more than 50 percent of the beneficial interests in the trust; or (4) in the case of a nonprofit organization or other organization without owners or persons having beneficial interests (nonstock organization), including a governmental entity, (a) more than 50 percent of the directors or trustees of the educational institution or nonstock organization are either representatives of, or are directly or indirectly controlled by, the other entity or (b) more than 50 percent of the directors or trustees of the nonstock organization are either representatives of, or are directly or indirectly controlled by, one or more persons that control the educational institution. For this purpose, a ''representative'' means a trustee, director, agent, or employee, and ''control'' includes the power to remove a trustee or director and designate a new trustee or director. Finally, the proposed regulations stated that section 318, which contains rules for determining constructive ownership of stock, applies for purposes of determining ownership of stock in a corporation, and similar principles apply for purposes of determining ownership of an interest in any other entity.

Commenters stated generally that use of the proposed definition of ''control'' would result in educational institutions' being required to take into account assets and net investment income that the educational institutions do not actually control and that they will never receive because the assets and income actually belong to unrelated third parties. The commenters also stated that such a rule is inconsistent with Congressional intent to include assets and income of related organizations only when the educational institution actually has control over the use of the related organization's assets and net investment income, and would not address Congressional concerns that educational institutions might attempt to avoid the section 4968 excise tax by holding assets in structures that, as compared to direct ownership, represent a difference in form but not substance.

More specifically, commenters stated that entities under common control with an educational institution could be deemed to be controlled by the educational institution, contrary to reality and thus inappropriately inflating the net investment income of the educational institution. In addition, the commenters stated that including controlled taxable entities, partnerships, split interest trusts, and employee benefit plans as related organizations for purposes of section 4968 would lead to double or triple taxation.

Parts 7.a.i. through v. of this Summary of Comments and Explanation of Revisions address entities that commenters recommended disregarding in applying the related organization provisions of section 4968(d): Taxable corporations; partnerships and other pass-through entities; certain trusts; employee benefit plans; and decedent's estates. Part 7.b of this Summary of Comments and Explanation of Revisions describes the rules for determining whether an educational institution will be considered to ''control'' an entity that is not disregarded for purposes of section 4968(d). Part 7.c of this Summary of Comments and Explanation of Revisions addresses the application of the rule that assets and net income of a controlled entity will be treated as the assets and net income of only one educational institution. Part 7.d of this Summary of Comments and Explanation of Revisions addresses the application of the rule that assets and net investment income of certain related organizations that are not intended or available for the use or benefit of an educational institution are not taken into account by the institution.

i. Taxable Corporations

The preamble to the proposed regulations stated that, because the net investment income that a taxable entity distributes or transfers to an educational institution has already been taxed, the Treasury Department and the IRS did not consider it consistent with Congressional intent to tax the income again under section 4968. Furthermore, with regard to the assets of a taxable corporation that is a related organization, the educational institution likely already has included the value of the shares of the corporation's stock that it owns in its non-exempt use assets; however, the stock value may differ from the value of the taxable corporation's underlying assets. The proposed regulations requested comments on how to account for this difference without double-counting the assets, as well as more general comments on the treatment of taxable entities that may be related organizations for purposes of section 4968.

Commenters agreed that educational institutions should not be required to take into account the net investment income of a related organization that is a taxable entity, stating that this would result in double, and sometimes triple, taxation (U.S. Federal income tax at the entity level on the taxable entity's income; section 4968 tax on any payments of net investment income by a taxable entity to the educational institution; and section 4968 tax on the net investment income of the controlled taxable entity that is treated as the institution's income under section 4968(d)). Furthermore, the commenters said that the value of the educational institution's holdings in the taxable entity would already be reflected on the educational institution's books, and, if the educational institution owned more than 50 percent, but less than 100 percent, of the taxable entity, the proposed definition would attribute to the institution income and assets that actually belong to unrelated third parties.

To prevent this multiple taxation of a taxable entity's net investment income and to prevent overcounting of a taxable entity's assets, these final regulations exclude from the definition of ''related organization'' a taxable corporation and, as described in part 7.a.iii. of this Summary of Comments and Explanation of Revisions, taxable trusts, in each case whether foreign or domestic.

The Treasury Department and the IRS note that any investment-type income that is paid to an educational institution by a taxable entity (such as interest on money loaned by the institution to the taxable entity) is included in net investment income for purposes of section 4968(c) in the same manner as any other such investment-type income received by an institution from any other entity, regardless of whether the other entity is or is not controlled by the institution. In addition, for purposes of section 4968(b)(1)(D), the value of the educational institution's interest in a taxable entity is based on the fair market value of the interest on the last day of the preceding taxable year, rather than on the book value of the interest reflected on the educational institution's books and records.

ii. Partnerships and Other Pass-Through Entities

Commenters stated that the proposed regulations' definition of control of partnerships (*i.e.,* that ownership of more than 50 percent of the profits interest or capital interest in a partnership would result in the educational institution's being deemed to control the partnership), likewise would result in double taxation (section 4968 tax on the net investment income that is allocated to the educational institution by the partnership and section 4968 tax on the net investment income of the partnership that is treated as the institution's income under section 4968(d)), which is inconsistent with the principles of subchapter K. Furthermore, the value of the educational institution's interest in the partnership already would be reflected on the educational institution's books, and, if the educational institution owns more than 50 percent, but less than 100 percent, of the profits interest or capital interest in such partnership, the proposed definition would attribute to the institution income and assets that actually belong to other partners, including unrelated third parties.

One commenter stated that an educational institution often is a limited partner in an investment partnership and asked that the final regulations provide that an educational institution that is a limited partner in a partnership not be treated as controlling the partnership for purposes of section 4968. This commenter added that, even if an educational institution served as the general partner of a partnership, it would have limited powers to change equity holders' entitlements to the partnership income and thus would not control all of the income or assets of the partnership.

To prevent double taxation of a partnership's net investment income and overcounting of its assets, these final regulations exclude from the definition of ''related organization'' a partnership, S corporation, or other pass-through entity a portion of whose income flows through to the educational institution.

The Treasury Department and the IRS note that any net investment income that flows through to an educational institution is included in that institution's net investment income for purposes of section 4968(c). In addition, for purposes of section 4968(b)(1)(D), the value of an educational institution's partnership interest is the fair market value of the institution's partnership interest on the last day of the preceding taxable year, rather than the book value of that interest carried on the educational institution's books and records.

iii. Certain Trusts

Multiple commenters stated that the proposed regulations' definition of control of trusts, which provided that ownership of more than 50 percent of the beneficial interests in a trust results in an educational institution being deemed to control the trust, would lead to inequitable results. In particular, commenters recommended excluding split-interest trusts described in section 4947(a)(2) from the definition of related organization, stating that, with respect to charitable remainder trusts, an educational institution generally is not able to receive any benefit, and cannot use assets in the trust, until the termination of the interests of the income beneficiaries (which may be decades into the future). This is true even if the value of the educational institution's interest in the trust exceeds 50 percent of the present value of all beneficial interests in the trust. In addition, even though it is unlikely that an educational institution would receive any income from such a trust while the grantor is alive, income paid from a split-interest trust is not considered net investment income for purposes of section 4940(c) (*see* Notice 2004–35), and it seems inconsistent to treat income that would not be net investment income if it were received directly from the trust to be treated as net investment income when not received from the trust. Further, it seems inequitable and contrary to Congressional intent to tax an educational institution on income that is paid to the grantor or other non-charitable beneficiary during the grantor's lifetime. Finally, it would be difficult for an educational institution to obtain information about the income of a split-interest trust, as there is currently no Federal requirement for a split-interest trust to report this information to its remainder beneficiary(ies).

One commenter recommended that the final regulations provide that a charitable remainder trust is within the control of the institution only if the institution (1) has a vested remainder interest of at least 50 percent of all actuarial interests in the trust, (2) serves as the trustee of the trust, and (3) under the terms of the trust document, has the right as trustee to make distributions from the trust to itself as a charitable organization.

The Treasury Department and the IRS considered whether the present value of an educational institution's share of the remainder assets of a charitable remainder trust should be included as assets of the institution for purposes of the $500,000-of-assets-per-student test in section 4968(b)(1)(D), given that such assets can demonstrate creditworthiness and because money is fungible. However, the Treasury Department and the IRS have determined that, for ease of administrability for both educational institutions and the IRS, and in view of the risk that, as a result of market forces, the remainder eventually received by the educational institution could be significantly less than its present value each year, an educational institution will not count the assets of a charitable remainder trust as its own assets until the educational institution actually becomes entitled to those assets at the termination of the interest of the income beneficiary. If this were not the rule, an educational institution would have to determine annually its share of the fair market value of the assets of each charitable remainder trust for which the educational institution is a remainder beneficiary, even though the educational institution might not know it had a remainder interest in all cases, the educational institution's remainder interest could be given to another charity in some instances, and the educational institution might not receive its remainder interest if the trust's investment returns turn out to be insufficient for the trust to possess any assets at the termination of the interests of the income beneficiaries. An educational institution similarly would have difficulty determining such a trust's net investment income. Therefore, these final regulations provide that a charitable remainder trust is not considered to be a related organization for purposes of section 4968(d).

An educational institution will not be a remainder beneficiary of a charitable lead trust. Instead, some portion of the trust's income is payable currently to one or more charities for a term, after which the remaining assets of the trust will be payable to noncharitable beneficiaries. Thus, an educational institution does not have any right to or interest in the principal or remainder of such a trust. As an income beneficiary of a charitable lead trust, any income payable currently to an educational institution will be included in the institution's net investment income for the current year. (This is true whether the trust is a grantor trust (whose income is taxed to the deemed owner of the trust and for which there is no current income tax deduction for the current distribution to charity) or a nongrantor trust (whose income is taxed to the trust itself, subject to a charitable deduction).) Thus, because the assets of a charitable lead trust are not available to the educational institution, and its net investment income is already included in the educational institution's assets and net investment income as received, the final regulations exclude charitable lead trusts from the definition of a related organization.

In addition, because there are only limited circumstances in which the educational institution would have sufficient control over a trust to justify treating the trust as a related organization, the final regulations also exclude all other taxable trusts from the definition of a related organization except to the extent the educational institution is deemed to control the trust, as provided in part 7.b.ii.B of this Summary of Comments and Explanation of Revisions.

iv. Employee Benefit Plans

Commenters stated that various retirement and benefit plans (including but not limited to section 403(b), section 457, voluntary employees' beneficiary associations (VEBAs) under section 501(c)(9), and defined benefit plans), should be excluded from the definition of related organization for purposes of section 4968(d), stating that the beneficiaries of these plans are employees of the educational institutions and it was not the intent of Congress to tax the investment income of these entities. One commenter also asked that other assets that are set aside or dedicated by an educational institution to pay for the institution's commitment to provide certain employee benefits be excluded from the definition of related organization.

These final regulations base the determination of whether assets held by or related to an employee benefit plan of an educational institution are considered assets of the educational institution on whether the arrangement is considered to be a funded or nonfunded plan. An employer's obligation to pay an employee benefit generally is considered to be ''funded'' when the assets are set aside from the employer exclusively to provide for the employees' benefits in a manner that the assets are no longer subject to claims of the employer's general creditors and may not revert back to the employer's general assets for use by the employer. *See Sproull* v. *Commissioner,* 16 T.C. 244 (1951), *aff'd per curiam,* 194 F.2d 541 (6th Cir. 1952). For example, contributions to the section 501(a) trust of a section 401(a) qualified retirement plan are considered to fund the obligation to provide employees' future retirement benefits. Similarly, a section 403(b)(1) annuity contract or amounts held in a section 403(b)(7) custodial account are considered to ''fund'' the obligation to pay employees' section 403(b) retirement benefits. In each of these cases, the assets held in the trust, contract, or account are considered to be set aside to ''fund'' the employer's benefit obligation and are not treated as assets of the employer. Further, amounts held in a section 419(e) welfare benefit fund (including a VEBA) are set aside to provide welfare benefits for employees, are not subject to the claims of general creditors, and would not be treated as assets of the employer or as assets of a related organization.

In contrast, plans under section 457 are unfunded because funds are not set aside for the purpose of providing benefits to plan participants in a manner that would result in a ''funded'' obligation to provide benefits under the plan. Under section 457(b)(6), assets held pursuant to an eligible deferred compensation plan, including amounts held in a grantor trust, must remain solely the property and rights of the employer and would be subject to the claims of the employer's general creditors. See § 1.457–8(b)(2). Similarly, amounts set aside by an eligible employer intended to pay for benefits under an ineligible section 457(f) plan, including assets set aside in a grantor trust, are treated as assets of the employer and subject to the claims of the employer's general creditors. Accordingly, assets set aside and held by an educational institution, including in a grantor trust, to be used to pay the employees' benefits under an educational institution's section 457(b) or section 457(f) plan are considered assets of the educational institution. As a result, these final regulations provide that a grantor trust or other financing vehicle used in connection with these unfunded plans is a ''related organization'' for purposes of section 4968(d), and its assets will be treated as the assets of the educational institution. The Treasury Department and the IRS note that, because assets in an unfunded plan are available to the employer just like any other assets, they are not considered ''used directly in carrying out the institution's exempt purpose'' for purposes of section 4968(b)(1)(D).

Other unfunded employee benefits, such as a typical health flexible spending arrangement (health FSA) or accrued leave cashout program, have no related grantor trust or other financing vehicle but instead use the employer's general assets as a source of payment. Any general assets that are used to satisfy benefit obligations are considered assets of the employer. Thus, if the employer is an educational institution or is a related organization with regard to an educational institution, such assets are considered to be assets of the educational institution, and no special rule is needed in the regulations.

Solely for purposes of determining the status of an employee benefit plan as a funded or unfunded arrangement, an educational institution and all of its related organizations are treated as a single sponsor and payor of the benefits.

v. Decedents' Estates

A few commenters asked that the final regulations clarify that decedents' estates are not ''related organizations'' under section 4968(d). Commenters stated that, because a decedent's estate is a separate legal entity created at a person's death, it should not be considered a related organization under section 4968(d), and, in any case, an educational institution would not be in a position to control a decedent's estate. The Treasury Department and the IRS agree, and to eliminate any question for purposes of section 4968, these final regulations provide that a decedent's estate is not a related organization. However, the Treasury Department and the IRS note that any assets of an estate that ultimately are transferred to an educational institution will be considered the educational institution's assets upon receipt by the institution.

b. Control

As stated in part 7.a of this Summary of Comments and Explanation of Revisions, the first three categories of related organizations described in section 4968(d)(2) require the presence of an element of control to exist for an organization to be considered to be ''related'' to an educational organization, but the statute does not define the term ''control.'' The proposed regulations provided a definition of control based on section 512(b)(13)(D) and the regulations thereunder and requested comments on whether there are any circumstances in which this definition of control should be modified in the context of section 4968.

Commenters asserted that the proposed definition of control would lead to unintended and undesirable results. For example, commenters stated that the downward attribution rules of section 318 would cause all brother/sister organizations of an educational institution to be considered to be controlling each other and that an educational institution controlled by a church could be deemed to own all the assets of the church or the assets of another, unrelated church just because the two churches were invested in the same investment partnership.

The proposed regulation's definition of control did not differentiate between an educational institution's control of another organization or another organization's control of an educational institution. The Treasury Department and the IRS recognize that the types of entities that would be deemed to control an educational institution under the proposed rule are likely to be very different from those that would be controlled by an educational institution. In addition, the direction of control matters for purposes of determining whether all the assets and net investment income of a related organization are attributable to the educational institution or whether only the assets and net investment income that are intended or available for the use or benefit of the educational institution are attributable to the educational institution. Accordingly, these final regulations provide separate rules for the different relationships that may exist. Specifically, these final regulations, among other things, separately define control for organizations that control an educational institution, that are controlled by an educational institution, and that are controlled by one or more persons that also control an educational institution, and do not apply the downward attribution rules of section 318.

i. Controls Such Institution

The Treasury Department and the IRS anticipate that most applicable educational institutions are set up as nonstock organizations, but to cover all circumstances, these final regulations set out rules for control of various types of organizational forms.

Generally, an organization will be considered to control an educational institution if the organization owns (by vote or value) more than 50 percent of the stock or membership interest of the educational institution.

In the case of any educational institution that does not have stock or membership interests, the other organization will be considered to control an educational organization if the other organization (or one or more of its managers, directors, officers, trustees, or employees, acting only in their capacities as representatives of the organization) can (1) appoint or elect (which must include the power to remove and replace) more than 50 percent of the members of the educational institution's governing body (such as directors, officers, or trustees), or otherwise has an ongoing power to appoint or elect more than 50 percent of such members with reasonable frequency; (2) require the educational institution to make an expenditure (or prevent the educational institution from making an expenditure); or (3) require the educational institution to perform any act that significantly affects its operations (or prevent it from performing such an act). Such control includes control by aggregating votes or positions of authority (including by veto power) but applies regardless of the method by which the control is exercised or exercisable.

As discussed in part 7.d of this Summary of Comments and Explanation of Revisions, an educational institution generally does not take into account assets and net investment income of a related organization that controls the educational institution unless the assets and net investment income of the related organization are intended or available for the use or benefit of the educational institution. However, if a related organization both controls the educational institution as described in this paragraph and is also a supporting organization described in section 509(a)(3) during the taxable year with respect to the educational institution, as described in part 7.b.iv of this Summary of Comments and Explanation of Revisions, then the rule that attributes the largest amount of assets and net investment income of the related organization to the educational institution must be applied.

ii. Is Controlled by Such Institution

The Treasury Department and the IRS have determined that only tax-exempt corporations, certain trusts, and nonstock organizations controlled by an educational institution should be considered controlled related organizations with respect to an educational institution for purposes of determining an educational institution's assets and net investment income under section 4968(d)(1).

As discussed in part 7.d of this Summary of Comments and Explanation of Revisions, if an educational institution controls an organization under this definition, then it must take into account all the assets and net investment income of the controlled related organization, except as provided in parts 7.b.ii.B (relating to certain controlled trusts), 7.c (relating to no amount being taken into account with respect to more than one educational institution), 7.d.iii (relating to certain organizations that were Type III supporting organizations with respect to an educational institution on December

31, 2017), and 7.d.iv (relating to when assets used directly in carrying out a related organization's exempt purpose are considered to be used directly in carrying out the educational institution's exempt purpose) of this Summary of Comments and Explanation of Revisions.

A. Tax-Exempt Corporations

No comments were received relating to the proposed rule for control of tax-exempt corporations. Thus, these final regulations retain the proposed rule and provide that a tax-exempt corporation is controlled by an educational institution if the educational institution owns (by vote or value) more than 50 percent of the voting and nonvoting stock or membership interest of the tax-exempt corporation.

B. Trusts

As discussed in part 7.a.iii of this Summary of Comments and Explanation of Revisions, several commenters stated that the proposed rule for control of trusts, which provided that control of a trust with beneficial interests means ownership of more than 50 percent of the beneficial interests in the trust, would not appropriately capture trusts that are controlled by the educational institution within the generally accepted meaning of that term. Commenters stated that the trustee of a trust does not control a trust in a way that is relevant for purposes of section 4968, because the trustee is required to administer the trust in accordance with, and to the extent of the trustee's duties and powers as determined by, the terms of the trust and applicable law. One commenter suggested that, given the limited roles of the trustee and the beneficiary, an educational institution should be considered to control a trust only if the educational institution is both a beneficiary and a trustee with the discretionary power to make current distributions of the trust's income and/or principal to itself, pursuant to the terms of the trust.

The Treasury Department and the IRS agree with commenters that a control rule for trusts based on an educational institution having a more than 50 percent beneficial interest leads to unintended results. However, the Treasury Department and the IRS believe that the commenter's recommended rule is too narrow and could allow an educational institution to transfer endowment assets into a trust that it would not be considered to control under the recommended rule, but that it did control in substance.

The Treasury Department and the IRS acknowledge that the concept of control does not comport well with trusts. Possibly the only person with control over a trust is a person with the power to revoke the trust; even the trustee's ''control'' is limited by the provisions of the trust instrument and applicable law. In attempting to construct a replacement for the control rule for trusts to be used in the context of section 4968, the Treasury Department and IRS identified the four specific circumstances under which a trust should be deemed to have a relationship with the educational institution that is sufficiently similar to that generally intended by the concept of control. However, in two of these circumstances, these final regulations recognize that the deemed control is only with regard to some of the assets of the trust; consequently, in the third and fourth circumstances explained in the subsequent paragraphs, only a portion of the trust is considered to be a related organization and only some of the assets and net investment income are attributed to the educational institution.

The first circumstance is where the educational institution is the sole permissible trust beneficiary. In this circumstance, several factors would be irrelevant, such as the identity of the trustee, the timing and standards for making trust distributions, and the donors to the trust. To prevent the existence of another trust beneficiary, whether purely discretionary or with only a minimal interest in the trust, from being used to avoid this rule, the test refers to the educational institution being ''substantially'' the sole trust beneficiary.

A second circumstance is where the trust is a pooled income fund described in sections 642(c)(3) and 642(c)(5). Although a certain portion of the net income of the fund is payable on a current basis to the donors to the fund, the fund is managed by the educational institution, the educational institution is the sole remainderman of the fund, and a portion of the fund becomes payable to the educational institution as each donor's interest expires. Given the different times (generally based on the date of death of individual donors) when portions of the trust principal will become payable to the educational institution, and the control of the fund by the educational institution, the Treasury Department and the IRS have determined that it is appropriate to deem a pooled income fund described in sections 642(c)(3) and 642(c)(5) to be controlled by that institution.

A third circumstance is where the trust has been funded with assets of the educational institution. If, and only to the extent that, the trust's funding consisted of assets contributed to the trust by the educational institution (or by a person controlled by the educational institution), the Treasury Department and the IRS concluded that the trust's assets and net income should be attributed to the educational institution.

Finally, the Treasury Department and the IRS concluded that any portion of a trust that the educational institution (or a person controlled by the educational institution) can demand or cause to be distributed to the educational institution (or a person controlled by the educational institution) should be attributed to the educational institution.

Therefore, these final regulations provide that a trust is a related organization, and an educational institution is deemed to control that trust, only: (1) If the educational institution is substantially the sole permissible trust beneficiary or appointee of both income and principal, whether or not the timing of distributions is subject to the trustee's discretion; (2) if the trust is a pooled income fund described in section 642(c)(3) and (5); (3) if, but only to the extent that, the assets of the trust were contributed to the trust by the educational institution (or by a person controlled by the educational institution, as determined under these regulations); or (4) if, but only to the extent that, the educational institution (or a person controlled by the educational institution, as determined under these regulations) has the right to demand (or can otherwise cause) a distribution of principal from the trust to the educational institution (or a person controlled by the educational institution).

For purposes of this definition, a person is controlled by an educational institution if the educational institution has the power to remove and replace such person or otherwise controls the person under one of the tests in § 53.4968–3(b)(2)(i), (ii), or (iii), with similar principles applying for purposes of determining control of any other form of entity.

C. Nonstock Organizations

One commenter objected to the proposed rule for control of nonstock organizations, stating that the portion of the rule that is based on directors or trustees of the educational institution being representatives of the other organization often incorrectly determines which entity controls the other, as the presence of common directors or trustees alone is not determinative of control. The commenter stated that the representatives test from the proposed regulations could be especially devastating to hierarchical religious organizations using corporation sole or similar structures, which have neither directors nor trustees. If one made a natural extension of the proposed rule by treating the incumbent officer of a ''corporation sole'' as a sole director or trustee, hierarchical religious organizations could be affected because an ecclesiastical officeholder could not be on the board of any educational institution without causing that religious organization to be deemed to be controlled by that educational institution. The commenter stated that control tests found in other sections of the Code relating to tax-exempt organizations, such as the control tests found in sections 507, 509, 4911, 4941, 4942, and 4943, would be more relevant and appropriate for purposes of section 4968. For example, these tests include the power to cause a certain act, often acting solely in the capacity of foundation manager.

The Treasury Department and the IRS agree that a modified version of control for nonstock organizations that is based on the power of the educational institution (or one or more of its managers, directors, officers, trustees, or employees acting only in the capacity as a representative of the educational institution) to cause (or prevent) a certain act would also appropriately reflect control by the educational institution over the nonstock organization.

Thus, these final regulations provide that an educational institution controls a nonstock organization if the educational institution (or one or more of its managers, directors, officers, trustees, or employees acting only in those capacities) can (1) appoint or elect (which must include the power to remove and replace) more than 50 percent of the members of the nonstock organization's governing body (such as directors, officers, or trustees), or otherwise has the ongoing power to appoint or elect more than 50 percent of such members with reasonable frequency; (2) require the nonstock organization to make an expenditure (or prevent the organization from making an expenditure); or (3) require the nonstock organization to perform any act that significantly affects its operations (or prevent it from performing such an act). Such control includes control by aggregating votes or positions of authority (including by veto power) but applies regardless of the method by which the control is exercised or exercisable.

iii. Is Controlled by One or More Persons That Also Control Such Institution

The proposed regulations provided a rule relating to control of a nonstock organization by one or more persons that also control an educational institution, finding control if more than 50 percent of the directors or trustees of the nonstock organization are directly or indirectly controlled by one or more persons that control the educational institution.

In recognition that the other organization might be other than a nonstock organization, these final regulations provide a separate rule for organizations that are controlled by one or more persons that also control such institution. Under these final regulations, an organization is controlled by one or more persons that also control the educational institution if more than 50 percent of the members of the governing body of the other organization is directly or indirectly controlled by persons that comprise more than 50 percent of the members of the governing body of the educational institution.

As discussed in part 7.d of this Summary of Comments and Explanation of Revisions, an educational institution does not take into account assets and net investment income of a related organization that is controlled by one or more persons that also control the educational institution unless the assets and net investment income are intended or available for the use or benefit of the educational institution. However, if a related organization is both (1) controlled by one or more persons that also control the educational institution, as described in this part 7.b.iii, and also is (2) controlled by the educational organization, as described in part 7.b.ii of this Summary of Comments and Explanation of Revisions or is also a supporting organization described in section 509(a)(3) during the taxable year with respect to the educational institution, as described in part 7.b.iv of this Summary of Comments and Explanation of Revisions, then the rule that attributes the largest amount of assets and net investment income of the related organization to the educational institution must be applied.

Nevertheless, the exceptions allowing certain assets and net investment income to not be taken into account described in parts 7.b.ii.B (relating to certain controlled trusts), 7.c (relating to no amount being taken into account with respect to more than one educational institution), 7.d.iii (relating to certain organizations that were Type III supporting organizations with respect to an educational institution on December 31, 2017), and 7.d.iv (relating to when assets used directly in carrying out a related organization's exempt purpose are considered to be used directly in carrying out the educational institution's exempt purpose) of this Summary of Comments and Explanation of Revisions, continue to apply.

iv. Supporting Organizations Described in Section 509(a)(3)

Section 4968(d)(2)(C) includes within the definition of related organization any supporting organization (as described in section 509(a)(3)) during the taxable year with respect to the educational institution.

One commenter noted that a Type I supporting organization [7] controlled by a community foundation that supports a class of entities that includes an educational institution within the class should be considered to be a Type I supporting organization only ''with respect to'' the controlling community foundation and not ''with respect to'' an educational institution. The commenter suggested that an organization be considered a supporting organization with respect to the educational institution only if the supporting organization meets the organizational, operational, and relationship tests with respect to the educational institution, considered in isolation. The Treasury Department and the IRS agree that a section 509(a)(3) organization is a supporting organization ''with respect to'' an educational institution only if the supporting organization meets the organizational, operational, and relationship tests with respect to the educational institution, and have clarified this point in these final regulations.

The commenter further suggested that an organization be deemed to be described in section 509(a)(3) with respect to an educational institution only if (1) it is described in section

[7] Organizations described in section 509(a)(3) are known as ''supporting organizations.'' Supporting organizations achieve their public charity status by providing support to one or more organizations described in section 509(a)(1) or (2), which, in this context, are referred to as ''supported organizations.'' To be described in section 509(a)(3), an organization must satisfy several tests, including having one of three ''relationships'' with one or more supported organizations. A supporting organization that is operated, supervised or controlled by one or more supported organizations is known as a ''Type I'' supporting organization. A supporting organization that is supervised or controlled in connection with one or more supported organizations is known as a ''Type II'' supporting organization. A supporting organization that is operated in connection with one or more supported organizations is known as a ''Type III'' supporting organization.

509(a)(3); (2) it bears a Type I, Type II, or Type III relationship to the educational institution; and (3) substantially all, or at least a majority, of its activities are for the benefit of, perform the functions of, or carry out the purposes of the educational institution or other public charities controlled by the educational institution. The Treasury Department and the IRS disagree with this reading because a supporting organization may be a supporting organization (as described in section 509(a)(3) and the regulations under section 509(a)(3)) with respect to the educational institution, despite the fact that less than a majority of its activities are for the benefit of, perform the functions of, or carry out the purposes of the educational institution or other public charities controlled by the educational institution. Thus, these final regulations do not adopt this recommendation.

The commenter noted that a supporting organization that is not a supporting organization ''with respect to'' an educational institution may still be related to the institution under one of the other tests, and that a Type I or Type II supporting organization with respect to the educational institution may be considered both a supporting organization with respect to the educational institution described in section 4968(d)(2)(C) and an organization controlled by the educational institution described in section 4968(d)(2)(A) or an organization controlled by one or more persons that also control the educational institution described in section 4968(d)(2)(B). The Treasury Department and the IRS agree, but in cases in which an organization is a related organization with respect to an educational institution on more than one basis, if one of the bases is that the organization is either controlled by the educational institution as described in part 7.b.ii of this Summary of Comments and Explanation of Revisions, or is a supporting organization (as described in section 509(a)(3)) with respect to the educational institution during the taxable year, then the rule that attributes the largest amount of assets and net investment income of the related organization to the educational institution must be applied.

v. Constructive Ownership

The proposed regulations provided that the principles of section 318 apply for purposes of determining ownership of stock in a corporation and that similar principles apply for purposes of determining ownership in any other entity.

Commenters noted that section 318 provides rules for attribution from entities under section 318(a)(2) (upward attribution) and to entities under section 318(a)(3) (downward attribution). In general, under upward attribution, (1) partners in a partnership are each considered to own a proportionate share of stock owned by or for the partnership; (2) beneficiaries of a trust are each considered to own a proportionate share of stock owned by or for the trust based on their actuarial interests in the trust; and (3) a person that owns stock representing 50 percent or more of the value of a corporation is considered to own a proportionate share of the stock owned by or for such corporation. In general, under downward attribution, partnerships and trusts are considered to own stock owned by or for their partners and beneficiaries, respectively, and corporations are considered to own stock owned by or for a person that owns stock representing 50 percent or more of the value of the corporation. Commenters noted that application of the downward attribution rules can lead to an institution being deemed to control an organization that it does not actually control.

The Treasury Department and the IRS agree with commenters that application of the principles of section 318(a)(3) may lead to unintended results. Thus, these final regulations provide that the principles of section 318(a)(2) apply for purposes of determining ownership of stock in a corporation, and similar principles apply for purposes of determining ownership of interests in any other entity.

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

As noted at the beginning of this part 7, section 4968(d)(1) provides, in part, that for purposes of determining the aggregate fair market value of an institution's assets and its net investment income, the assets and net investment income of all related organizations with respect to the educational institution are treated as assets and net investment income, respectively, of the educational institution. However, section 4968(d)(1)(A) provides an exception under which no such amount is taken into account with respect to more than one educational institution.

In order to effectuate the exception contained in section 4968(d)(1)(A), the proposed regulations provided that, in any case in which an organization is a related organization with respect to more than one educational institution, the assets and net investment income of the related organization must be allocated among the educational institutions as to which the organization is a related organization. The proposed regulations provided that such allocation must be made in a reasonable manner, taking into account all facts and circumstances, and must be consistently applied across all related organizations. The Treasury Department and the IRS requested comments on whether more specific guidance is required concerning the allocation of a related organization's assets and net investment income among multiple educational institutions being supported by the same related organization, and if so, what such additional guidance should be provided. One commenter agreed with the proposed regulation, saying that any reasonable methodology that takes into account all facts and circumstances and is applied consistently across all related organizations is appropriate for purposes of avoiding double-counting of related organizations' assets and income. Thus, these final regulations adopt the proposed rule and add that the allocation must be consistently applied.

d. Assets and Net Investment Income of Related Organizations

For purposes of attributing assets and net investment income of related organizations to educational institutions, section 4968(d)(1)(B) provides that, unless a related organization is controlled by the educational institution or is a supporting organization described in section 509(a)(3) with respect to such institution for the taxable year, assets and net investment income of the related organization that are not intended or available for the use or benefit of the educational institution are not taken into account.

Put another way, if a related organization (1) controls the educational institution (but is not described in section 509(a)(3) with respect to the educational institution for the taxable year as described in part 7.b.iv of this Summary of Comments and Explanation of Revisions), (2) is controlled by one or more persons that also control such institution (but is neither controlled by the educational institution as described in part 7.b.ii of this Summary of Comments and Explanation of Revisions nor is described in section 509(a)(3) with respect to the educational institution), or (3) is a supported organization (as defined in section 509(f)(3)) with respect to the educational institution during the taxable year, then the related organization's assets and net investment income are taken into account as assets and net investment income of the educational institution only to the extent the assets and net investment income are intended or available for the use and benefit of the educational institution.

However, if a related organization either (1) is controlled by the educational institution or (2) is a supporting organization described in section 509(a)(3) with respect to such institution for the taxable year, then all the assets and net investment income of the related organization are considered assets and net investment income of the educational institution, except as provided in parts 7.b.ii.B (relating to certain controlled trusts), 7.c (relating to an exception under which no such amount is taken into account with respect to more than one educational institution), 7.d.iii (relating to certain organizations that were Type III supporting organizations with respect to an educational institution on December 31, 2017), and 7.d.iv (relating to when assets used directly in carrying out a related organization's exempt purpose are considered to be used directly in carrying out the institution's exempt purpose) of this Summary of Comments and Explanation of Revisions.

i. Related Organizations That Control the Educational Institution, Are Controlled by One or More Persons That Also Control the Educational Institution, or Are Supported Organizations (as Defined in Section 509(f)(3)) With Respect to the Educational Institution During the Taxable Year

As discussed in part 7.d of this Summary of Comments and Explanation of Revisions, the assets and net investment income of certain related organizations are taken into account only to the extent that they are intended or available for the use and benefit of the educational institution. In determining which assets and net investment income are considered ''intended or available for the use and benefit of'' the educational institution, the Conference Report states, ''[f]or example, assets of a related organization that are earmarked or restricted for (or fairly attributable to) the educational institution would be treated as assets of the educational institution, whereas assets of a related organization that are held for unrelated purposes (and are not fairly attributable to the educational institution) would be disregarded.'' H. Rept. 115–466, 115th Cong., 1st sess., at 555 (December 15, 2017).

The proposed regulations provided that when an educational institution is determining which assets and net investment income are ''intended or available for the use or benefit of'' the educational institution, the educational institution must make an allocation between those assets and net investment income that are 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. 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.

One commenter agreed with this approach, stating that it is reasonable to permit an educational institution to take into account its own unique facts and circumstances and use any reasonable method to allocate the assets and net investment income.

The preamble to the proposed regulations further explained that assets and net investment income of such a related organization are intended or available for the use and benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for the benefit of, or are otherwise fairly attributable to, the educational institution. Conversely, assets and net investment income of a related organization are not intended or available for the use and benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for another entity or for unrelated purposes or otherwise are not fairly attributable to that educational institution.

The preamble to the proposed regulations requested comments on situations in which an organization's assets or net investment income is not specifically earmarked or restricted for the benefit of any particular organization but otherwise is fairly attributable to the educational institution or to another organization. For example, the proposed regulations asked whether, absent any earmarking or restriction, total distributions from a related organization to an educational institution in one taxable year should establish a presumption for section 4968 purposes that at least an equal amount is fairly attributable to that educational institution for the following taxable year, absent demonstrated facts and circumstances supporting attribution of a lesser amount.

One commenter stated that, because earmarked and restricted funds are subject to legally binding requirements that the assets must be used solely for the designated recipient, such funds are a clear example of assets ''intended for'' a particular organization. In contrast, internal board decisions to allocate funds to certain purposes do not typically convert funds into restricted funds because the board still has authority to reverse its previous decision without obtaining any outside consent. However, the commenter noted that certain assets that have been affirmatively designated for use by an educational institution could be ''intended for'' the institution, and thus ''fairly attributable,'' even if not subject to a binding restriction. This commenter recommended that the unrestricted, undesignated assets of a related organization will not be treated as intended or available for the educational institution unless they have been affirmatively designated or appropriated for the educational institution or made available for the educational institution to draw upon at will; in other words, if they have been approved and directed by the related organization for use by the educational institution. These final regulations adopt this recommendation.

A few commenters said that total distributions from a related organization to an educational institution in one taxable year should not establish a presumption for section 4968 purposes that at least an equal amount is fairly attributable to the educational institution for the following taxable year. One commenter recommended creating a rebuttable presumption based upon an average of distributions from the related organization over a number of years. Another commenter noted that there is no need to estimate possible future distributions because the excise tax under section 4968 is based on data that is known at the time the annual return is being prepared, so the exact amount of distributions do not have to be estimated. This commenter stated that if such a presumption did apply, it should be rebuttable based on facts showing that the previous year's amounts distributed were for special projects and not ''intended or available for'' the educational institution the following year. In response to the comments, these final regulations do not include a presumption based on previous distributions.

ii. Related Organizations That Are Controlled by the Educational Institution or That Are Supporting Organizations (as Described in Section 509(a)(3)) With Respect to the Educational Institution During the Taxable Year

If a related organization (1) is controlled by an educational institution, as described in part 7.b.ii of this Summary of Comments and Explanation of Revisions, or (2) is a supporting organization (as defined in section 509(a)(3) and described in part 7.b.iv of this Summary of Comments and Explanation of Revisions) with respect to the educational institution during the taxable year, then the assets and net investment income of the related organization must be taken into account as assets and net investment income of the educational institution, regardless of whether the assets and net investment income are earmarked, restricted for the benefit of, or otherwise are fairly attributable to that educational institution, and even if they are specifically earmarked or restricted for another entity or for unrelated purposes or otherwise are not fairly attributable to that educational institution. However, the special rule in section 4968(d)(1)(A) continues to apply, preventing the assets and net investment income of the related organization from being taken into account by more than one educational institution. See part 7.c of this Summary of Comments and Explanation of Revisions. In addition, assets that are used directly for the related organization's exempt purpose are considered used directly in carrying out the educational institution's exempt purpose for purposes of section 4968(b)(1)(D), as described in parts 5.e and 7.d.iv of this Summary of Comments and Explanation of Revisions. There also is a special rule for related organizations that were Type III supporting organizations with respect to the educational institution on December 31, 2017, as described in part 7.d.iii of this Summary of Comments and Explanation of Revisions.

iii. Special Rule for Related Organizations That Were Type III Supporting Organizations With Respect to an Educational Institution on December 31, 2017

In recognition that section 509(a)(3) Type III supporting organizations, unlike section 509(a)(3) Type I and Type II supporting organizations, are not directly or indirectly controlled by their supported organizations,[8] and because educational institutions may not be able to get the needed information from their Type III supporting organizations on a timely basis, the proposed regulations provided a special rule for related organizations of an educational institution that were Type III supporting organizations with respect to an educational institution on December 31, 2017.

That special rule allowed an educational institution with a related organization that was a Type III supporting organization with respect to the educational institution on December 31, 2017, to take into account only the assets and net investment income of the related Type III supporting organization that are intended or available for the use and benefit of the educational institution, rather than the value of all of that organization's assets or amount of net investment income. The proposed regulations provided that an educational institution can determine whether the assets and net investment income of such a Type III supporting organization are intended or available for the use and benefit of the educational institution using any reasonable method. The proposed regulations set out one method for determining the amount of net investment income available to the educational institution that would be considered to be reasonable (*i.e.,* using all the distributions received from a Type III supporting organization subject to this special rule as net investment income of the educational institution each year) and one method for determining assets available to the educational institution that would be considered to be reasonable (*i.e.,* using the distributions received from a Type III supporting organization to calculate the percentage of the Type III supporting organization's total net income that was distributed to the educational institution, and using the same percentage to calculate the value of the underlying assets of the Type III supporting organization that are intended or available for the use and benefit of the educational institution each year). The proposed regulations requested comments on whether additional guidance pertaining to Type III supporting organizations was needed.

One commenter stated that the safe harbor methods in the proposed regulations would in many cases lead to strange results, stating that the fact that a particular subsidiary makes a distribution to an educational institution in one year in no way implies that the educational institution has similar amounts available to it in future years, let alone to a corresponding portion of the related organization's entire asset base. The commenter suggested that only the amounts actually distributed or appropriated to the educational institution should be treated as intended or available for the educational institution.

For consistency with the general rule for determining which assets and net investment income are considered ''intended or available for the use and benefit of'' an educational institution, and in response to the comment, these final regulations do not include the safe harbor method in the proposed regulations. Instead, these final regulations provide that a method using assets and net investment income of the Type III supporting organization (with respect to the educational institution as of December 31, 2017), that are specifically earmarked for an educational institution, are restricted for the benefit of an educational institution, and are otherwise fairly attributable to an educational institution (such as those that have been affirmatively designated or appropriated for the educational institution or made available for the educational institution to draw upon at will) will be deemed to be reasonable.

Several commenters asked that the special rule for related organizations that were Type III supporting organizations with respect to the educational institution on December 31, 2017, be extended to cover all Type III supporting organizations. One asked that the special rule be extended to Type I and Type II supporting organizations, one asked that it be extended to split-interest trusts, and one asked that it cover all related organizations for which the educational institution lacks ''effective control.''

Although the Treasury Department and the IRS have concluded that a transition rule with respect to entities that were Type III supporting organizations with respect to an educational institution on December 31, 2017, is appropriate, extending this rule to other organizations would be contrary to the statute. In addition, the Treasury Department and the IRS have concluded that excluding certain categories of organizations from the definition of related organization, as described in part 7.a of this Summary of Comments and Explanation of Revisions, and explaining that a supporting organization must be described in section 509(a)(3) ''with respect to'' an educational institution during the

[8] As mentioned in footnote 9 of this preamble, there are three types of supporting organizations: Type I, Type II, and Type III. The relationship of a Type III supporting organization with its supported organization(s) is much more attenuated than the other two types.

taxable year, as described in part 7.b.iv of this Summary of Comments and Explanation of Revisions, address most of the commenters' concerns.

iv. Interaction With Section 4968(b)(1)(D)

As described in part 5.f of this Summary of Comments and Explanation of Revisions, these final regulations provide that an asset of a related organization that is treated as an asset of an educational institution by section 4968(d) and that is used directly in carrying out an educational institution's exempt purpose is considered to be used directly by the educational institution in carrying out its exempt purpose for purposes of section 4968(b)(1)(D). In addition, an asset of a related organization described in section 501(c)(3) that is treated as an asset of an educational institution by section 4968(d) and that is used directly in carrying out the related organization's exempt purpose is considered to be used directly by the educational institution in carrying out its exempt purpose for purposes of section 4968(b)(1)(D).

8. Penalty Waiver

One commenter asked that any penalties arising from underpayment of the excise tax for tax years prior to and including tax years in which final guidance is issued be waived. A waiver of penalties is beyond the scope of these regulations. In addition, these final regulations are not effective until the taxable year beginning after publication of the final regulations. Thus, applicable educational institutions will have up to a year to comply with the final regulations, and for prior taxable years applicable educational institutions can comply with the statute using a reasonable good faith interpretation.

Applicability Date

These final regulations apply to taxable years of an educational institution beginning after October 15, 2020.

Special Analyses

Executive Orders 12866, 13563, and 13771 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. The Executive Order 13771 designation for this regulation is regulatory.

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

I. Need for Regulation

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

The Treasury Department and the IRS received 18 formal comments regarding these proposed definitions and rules, and there was a degree of taxpayer uncertainty as to whether the definitions of the various terms and whether the rules for computing net investment income would remain the same as those provided in the notice of proposed rulemaking.

Pursuant to section 6(a)(3)(B) of Executive Order 12866, the following qualitative analysis provides further details regarding the anticipated impacts of the final regulations. The statute and the final regulations are briefly described in Part II of this Special Analyses section. The baseline used for the analysis is described in Part III. Part IV describes the types of entities affected by the proposed regulations. Part V provides a qualitative assessment of the potential economic effects, including the benefits and costs, of the proposed regulations compared to the baseline.

II. The Statute and the Final Regulations

Section 4968 imposes a 1.4 percent excise tax on the net investment income of applicable educational institutions. Under the statute, an ''applicable educational institution'' is an eligible educational institution (which is described in section 25A(f)(2)) that has at least 500 tuition-paying students during the preceding taxable year, more than 50 percent of whom are located in the United States, that is not a state college or university, and the fair market value of the assets of which (other than those assets that are used directly in carrying out the institution's exempt purpose) is at least $500,000 per student at the end of the preceding taxable year. Under section 4968, net investment income is determined under rules ''similar to'' the rules of section 4940(c) (the rules for the calculation of the net investment income of private foundations). In addition, the statute contains a rule under which the assets and net investment income of related organizations generally are treated as the assets and net investment income of the educational institution.

Section 4968 does not define the terms ''student,'' ''tuition-paying student,'' or ''assets used directly in carrying out the institution's exempt purpose.'' Section 4968(c) states that, for the purposes of the excise tax in section 4968, net investment income is determined under rules ''similar to'' the rules of section 4940(c) but does not define what is meant by ''similar to.'' Section 4968 does not define the term ''control'' as it relates to the definition of a ''related organization with respect to an educational institution.'' The final regulations provide general definitional guidance with respect to these and other terms and rules relevant to the implementation of the statute.

III. Baseline

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

IV. Affected Entities

One researcher used data from the Integrated Post-Secondary Education Data System (IPEDS) on endowment values at the end of the 2015–2016 academic year and enrollment data to estimate the number of institutions at risk of having liability under this excise tax.[9] Under the assumption that none of the assets in the endowment are for

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

exempt purposes, he estimates that 23 institutions are likely to be currently subject to tax. Using the same IPEDS data, another researcher estimated that in 2016, among four-year public and not-for-profit private institutions located in the United States with at least 500 full-time equivalent students, and excluding endowments held at the university system level, there were 27 endowments worth at least $500,000 per student.[10] These estimates do not take into account all of the provisions of the statute and regulations. For example, limiting this set of institutions to the not-for-profit private institutions subject to tax and excluding assets that are used for the institutions' exempt purpose would reduce the number of affected institutions. On the other hand, as both authors note, because the $500,000 per student threshold for the aggregate fair market value of assets (other than those assets which are used directly in carrying out the institution's exempt purpose) that in part determines whether the excise tax in section 4968 applies to an educational institution is not indexed for inflation, the number of institutions to which the excise tax in section 4968 applies is expected to increase over time. In addition, these studies did not consider assets held by related organizations; including such assets could increase the number of affected institutions.

V. Economic Effects of the Final Regulations

The Treasury Department and the IRS anticipate that the issuance of guidance pertaining to section 4968 will provide a marginal net economic benefit to the overall U.S. economy.

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

The guidance provided in the final regulations also ensures that the excise tax liability is calculated similarly across taxpayers, avoiding situations where one taxpayer receives preferential treatment over another taxpayer for fundamentally similar economic activity. For example, in the absence of these final regulations, an educational institution may have uncertainty over whether it is subject to the excise tax under section 4968 and what assets are used in determining the net investment income for purposes of the excise tax under section 4968. As a result, in the absence of guidance, similar institutions might take different positions and pay different amounts of tax, introducing economic inefficiency and inequity.

Based on this analysis, the Treasury Department and the IRS anticipate the net economic contribution of the final regulations will be modest and will be positive relative to not issuing any such guidance and conditional on the relevant statutes. In the proposed regulations, the Treasury Department and the IRS requested comments on a number of aspects of the proposed regulations, which included comments on the economic effects, any behavioral changes caused, or the unintended costs and benefits of the regulations. The Treasury Department and the IRS did not receive any comments on these issues.

VI. Economic Analysis of Specific Provisions

The regulations embody certain regulatory decisions that reflect the necessary exercise of regulatory discretion. These decisions specify more fully how section 4968 is to be implemented.

A. Clarifications of Definitions

Consistent with the statute, the final regulations provide that the term ''applicable educational institution'' means any eligible educational institution: (1) That had at least 500 tuition-paying students attending the institution during the preceding taxable year; (2) with more than 50 percent of whose tuition-paying students are located in the United States; (3) that is not described in the first sentence of section 511(a)(2)(B) (relating to state colleges and universities); and (4) the aggregate fair market value of the assets of which at the end of such preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purpose) is at least $500,000 per student attending the institution.

Many provisions of the final regulations clarify definitions related to the tax imposed by section 4968, minimizing the burdens entities bear to comply with the tax, and have little other economic impact. Clarifications reduce uncertainty, lower the effort required to infer which institutions are subject to the section 4968 tax and the potential for conflict if entities and tax administrators interpret provisions differently. Examples of clarifications include the definition of ''applicable educational institution,'' ''student,'' ''tuition-paying,'' ''located in the United States,'' and ''assets.''

i. Definition of ''Student''

The definition of ''applicable education institution'' relies on the definition of ''student.'' In section 25A(b)(3) and the Higher Education Act, a ''student'' is defined as a person enrolled in a degree, certification, or other program (including a program of study abroad approved for credit by the eligible educational institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution, and who is not enrolled in an elementary or secondary school.

The proposed regulations provided that the number of students of an educational institution (including for purposes of determining the number of students at a particular location) is based on the daily average number of full-time students attending such institution (with part-time students taken into account on a full-time student equivalent basis). Under the proposed regulations, the standards for determining part-time students, full-time students, full-time equivalents, and daily average are generally determined by each educational institution.

Two commenters recommended that the definition of ''student'' be expanded to include all students attending the institution even if not enrolled in a degree, certification, or other program leading to a recognized educational credential. One concern was that the term ''recognized educational credential'' was ambiguous.

The final regulations define the term ''student'' as a person who is enrolled and attending a course for academic credit from the institution and who is being charged tuition at a rate that is

[10] Hinrichs, Peter. ''College Endowments.'' Economic Commentary 2018–04 (May 17, 2018), Federal Reserve Bank of Cleveland, Table 1.

commensurate with the tuition rate charged to students enrolled for a degree.

ii. Definition of ''Tuition-Paying''

The proposed regulations provided that the term ''tuition-paying'' means the payment of any tuition or fees required for the enrollment or attendance of a student for a course of instruction at an eligible educational institution. The proposed regulations stated that this does not include any separate payment for supplies or equipment required during a specific course once a student is enrolled in and attending the course, or the payment of room and board or other personal living expenses. In addition, the proposed regulations provided that whether a student is ''tuition-paying'' is determined after taking into account any scholarships provided directly by the educational institution and any work study programs operated directly by the educational institution; however, scholarship payments provided by third parties, even if administered by the institution, are considered payments of tuition on behalf of the student.

Commenters sought clarification on how scholarships from different sources counted toward tuition, given that the proposed regulations considered tuition after taking into account scholarships and work-study programs offered directly from the institution. One commenter was specifically concerned with Federal and state financial aid and non-governmental scholarships not paid by the institution. The final regulations do not count Federal, state, and local grants or financial aid as ''tuition,'' but do count grants and scholarships provided by a non-governmental party other than the particular educational institution as ''tuition.''

In summary, ''tuition'' excludes payments made by or on behalf of the student by the institution or from any Federal, state, and local governmental sources. These clarifications in the final regulations will more easily allow institutions to determine the applicability of the statute.

iii. Definition of ''Located in the United States''

The proposed regulations provided that the term ''located in the United States'' refers to the location of a student, and that a student is considered to have been located in the United States if the student resided in the United States for at least a portion of the time the student attended the institution during the educational institution's preceding taxable year.

One commenter sought clarification on this definition, recommending that each institution be able to use any reasonable approach to consider which students are located in the United States, as long as it is consistently applied. The final regulations make explicit the commenter's suggestion.

iv. Clarifications of ''Assets Used Directly in Carrying Out an Institution's Exempt Purpose''

The final regulations also provide clarification of ''assets used directly in carrying out an institution's exempt purpose.'' The definition of an asset counted for purposes of section 4968 rests on whether the asset is used for an exempt purpose. If an asset is used for both an exempt purpose and for other purposes, and the exempt use represents 95 percent or more of the total use, the property is considered to be used exclusively for an exempt purpose. If the exempt use of such property represents less than 95 percent of the total use, the institution must make a reasonable allocation between exempt and nonexempt uses. Non-exempt assets generally include assets held for the production of income or for investment and property used to manage the institution's endowment.

A commenter recommended expanding the definition of exempt assets to include intangible assets and non-financial assets used in a functionally related business. Such functionally related businesses would be things like a school newspaper that generated ad revenue. The Treasury Department and IRS agreed that in certain circumstances these types of assets may be included in exempt assets.

Another aspect of what is considered as assets held directly for an exempt purpose is a reasonable cash balance to carry out the institution's purpose. The proposed regulations recognized that an amount equal to 1.5 percent of the fair market value of the educational institution's non-charitable use assets (*i.e.,* assets not actually used by an institution in carrying out its exempt purpose), determined without regard to the reduction for the reasonable cash balance, is deemed to be a ''reasonable cash balance'' that is excluded from the educational institution's asset base. These final regulations provide that a reasonable cash balance may be determined by any reasonable method and provide one example that would be deemed to be reasonable. The final regulations therefore increase the flexibility of educational institutions in establishing an appropriate reasonable cash balance.

Commenters also requested clarification of the treatment of assets of organizations related to the educational institution. The final regulations provide that an asset of a related organization that is treated as an asset of the educational institution (in accordance with section 4968(d) and § 53.4968–3(c)) and is used directly in carrying out the educational institution's exempt purpose is considered used directly by the institution in carrying out its exempt purpose. These final regulations further provide that an asset of a related organization that is treated as an asset of the educational institution is considered to be used directly in carrying out the educational institution's exempt purpose as long as (1) the related organization is described in section 501(c)(3) and (2) the asset is being used directly in carrying out the related organization's exempt purpose. Further discussion of ''related'' organizations is below.

B. Differences in Definition of ''Net Investment Income'' for Educational Institutions Versus Private Foundations

Section 4968(a) imposes a 1.4 percent excise tax on the net investment income of an applicable educational institution and on certain amounts of net investment income of certain related organizations. Section 4968(c) provides that net investment income is determined under rules similar to the rules of section 4940(c). Section 4940(c) defines net investment income for an excise tax on private foundations' net investment income.

Several commenters requested that the Treasury Department and IRS further tailor these rules to take into account differences between a private foundation subject to section 4940 and an educational institution subject to section 4968, including differences in funding sources, use of funds, structure, governance, and oversight. The Treasury Department and IRS responded by tailoring the final regulations to define net investment income more specifically for educational institutions.

Following the regulations under section 4940(c), the final 4968 regulations provide that net investment income generally is the amount by which the sum of the gross investment income and the capital gain net income exceeds the allowable deductions. Commenters sought clarification and modification of what is included as ''gross investment income'' and ''capital gain net income.''

i. Gross Investment Income

Commenters recommended clarifications and modification to what is included in gross investment income for purposes of section 4968. The final regulations specify that, consistent with section 4940(c), gross investment income generally means the gross amounts of income from interest, dividends, rents, payments with respect to securities loans, and royalties, but not including any such income to the extent it is included in computing the tax imposed by section 511.

In response to commenters, the final regulations exclude from the definition of gross investment income interest income from a student loan made by an educational institution (or a related organization) to a student of the institution in connection with the student's attendance at the institution. Section 4940(c) specifically includes student loan interest as gross investment income. Commenters noted that loans made by colleges and universities to students are not offered with the intent of earning investment income for the institution.

The final regulations also exclude from the definition of gross investment income rental income from the provision of housing to current students of the educational institution and from housing for faculty and staff if the housing is provided contingent on their roles as faculty or staff of the educational institution. The final regulations exclude from the definition of gross investment income royalty income that is derived from patents, copyrights, and other intellectual property and intangible property to the extent those assets were created by the institution's current students or faculty in their capacities as such. Commenters represented that it would be a significant administrative burden to capture all expenses and costs allocable to such royalty income. The Treasury Department and the IRS agree that applicable educational institutions produce intellectual property as part of the pursuit of knowledge by faculty and students. However, royalties from trademarks on the institution's logo or name, as well as royalties on property donated or sold to the educational institution, are not excluded from gross investment income under this rule.

ii. Capital Gains and Losses

Commenters addressed several aspects of the proposed rules for capital gain net income, including the taxation of capital gain net income on the sale of exempt use property; capital gain net income on the sale of donated property; the step-up rule for assets held in a partnership on December 31, 2017; and whether capital loss carryovers should be allowed.

a. Capital Gain Net Income on Sale of Exempt Use Property

In response to public comments, these final regulations provide that capital gain net income from the sale or exchange of property used by an institution for its exempt purpose is disregarded for the portion of the property that is used for the exempt purpose.

b. Capital Gain Net Income From the Sale of Donated Property

Commenters recommended that any appreciation that occurred prior to an institution's receipt of the donated property be excluded from the calculation of capital gain net income from the sale of donated property. Private foundations subject to section 4940 are generally passive grant-making organizations that have the ability to dispose of appreciated property by making a grant of the property instead of selling the appreciated property and making a grant in cash. Educational institutions, on the other hand, nearly always immediately liquidate the gifts and use the proceeds to fund the institution's activities; they therefore cannot avoid the net investment income from the sale of appreciated property like private foundations. In response, these final regulations provide that any appreciation in the value of donated property that occurred prior to the date of donation to the applicable educational institution is disregarded in calculating gain for purposes of section 4968.

c. Basis for Purposes of Determining a Distributive Share of Gain From the Sale or Other Disposition of an Asset Held in a Partnership

Commenters expressed concern with the proposed section 4968 rules proposing calculation of the basis of assets held in partnerships in which an educational institution owns an interest. Four commenters noted that it would be extremely burdensome for institutions to obtain documentation to establish their share of the basis of a particular partnership asset and that an asset-by-asset determination of gain, therefore, might not be possible.

The Treasury Department and the IRS acknowledge the problem described by commenters. These final regulations provide a method, described in paragraph 6.e. of the Summary of Comments and Explanation of Revisions, which generally enables an applicable educational institution to offset its distributive share of capital gain net income from partnership asset dispositions by using the applicable educational institution's adjusted step-up for such partnership (described in paragraph 6.e of the Summary of Comments and Explanation of Revisions), if any, at the time of such partnership asset disposition.

Specifically, the proposed regulations provided that, if an applicable educational institution held an interest in a partnership on December 31, 2017, and continuously thereafter, and the partnership held an asset on December 31, 2017, and continuously thereafter to the date of its disposition by the partnership, the applicable educational institution's basis in such asset (for purposes of determining the applicable educational institution's share of gain upon sale or other disposition of that asset) is not less than the fair market value of such asset on December 31, 2017, subject to all adjustments provided in the proposed regulations after December 31, 2017, and before the date of disposition.

d. Reduction of Capital Gain Net Income From a Partnership

Commenters stated that it would be very difficult, if not impossible, for institutions to obtain the basis documentation that would have been required under the proposed regulations in order to apply the proposed partnership asset basis step-up rule. As an alternative, two commenters recommended a method that would use the difference between the fair market value and outside basis of an applicable educational institution's partnership interest on December 31, 2017, to approximate the difference between the fair market value and inside basis of, and thus the amount of built-in gain in, the applicable educational institution's share of partnership assets on such date. The commenters stated that the difference between fair market value and tax basis of an applicable educational institution's partnership interest on December 31, 2017, should generally reflect the amount of the applicable educational institution's built-in gain in its share of the partnership's assets on such date, and that, because educational institutions should know the fair market values and tax bases of their partnership interests on December 31, 2017, they should be able to calculate the built-in gain in their partnership interests as of December 31, 2017.

Specifically, the commenters recommended that an applicable educational institution should be allowed to offset the distributive share of partnership capital gain net income after December 31, 2017, allocated by a partnership by the amount of the built-in gain the applicable educational institution had in its partnership interest, determined as of December 31, 2017. Under this approach, an applicable educational institution would determine its built-in gain in a partnership interest as of December 31, 2017, and then not report any capital gain allocated from that partnership after December 31, 2017, as being subject to section 4968 until the cumulative amount of such excluded gain exceeds the amount of built-in gain in the interest. The commenters recommended that this rule be applied on a partnership-by-partnership basis and be available to reduce the amount of an applicable educational institution's capital gain net income on a first-recognized basis.

These final regulations adopt an approach that is similar to the approach recommended by the commenters. These final regulations provide that, for each partnership interest an applicable educational institution held on December 31, 2017, the applicable educational institution may determine an unadjusted step-up amount that is equal to the excess, if any, of the fair market value of such partnership interest on December 31, 2017, over the adjusted basis of such partnership interest on December 31, 2017. For purposes of computing net investment income for taxable years beginning after December 31, 2017, an applicable educational institution will reduce its distributive share of capital gain net income from such partnership by the least of: (A) The applicable educational institution's share of applicable capital gain from such partnership (that is, both short-term and long-term capital gain for the first taxable year after December 31, 2017, but only long-term capital gain for subsequent years because short-term capital gains could not have been included in the amount of outside built-in gain as of December 31, 2017); (B) one-third of the applicable educational institution's unadjusted step-up for such partnership; or (C) the applicable educational institution's adjusted step-up for such partnership (which, in general, is its unadjusted step-up reduced by any capital gain that previously was excluded pursuant to either this rule or the partnership interest sale rule described in paragraph 6.d.iii. of the Summary of Comments and Explanation of Revisions).

e. Capital Loss Carryovers

A commenter represented that private foundations and educational institutions differ in their flexibility in regards to the treatment of sales of investments and operating budgets. Specifically, a private grant-making foundation, to the extent it has satisfied its minimum distribution requirements, can easily curtail its spending (and the realization of capital gains while converting investment assets to cash) by issuing fewer or smaller grant awards to manage its section 4940 tax liability. The commenter contrasted such a foundation with an educational institution that typically has a large operating budget with significant nondiscretionary expenses related to employees and infrastructure and must find ways to meet its ongoing cash needs, which may involve selling investments at particular times that may not be advantageous from an investment or tax perspective.

The Treasury Department and the IRS acknowledge the differences between private foundations subject to section 4940(c) and educational institutions in their missions, functions, and operating expenses. Based on these differences, these final regulations allow the use of capital loss carryovers consistent with the approach recommended by the commenter.

C. Related Organizations for Purposes of Net Investment Income and Assets

Section 4968(d)(1) provides that the assets and net investment income of any related organization with respect to an educational institution are to be treated as assets and net investment income, respectively, of the educational institution. The statute provides two exceptions: (1) No such amount is to be taken into account with respect to more than one educational institution, and (2) unless the related organization is controlled by the institution or is a supporting organization (as described in section 509(a)(3)) with respect to the institution for the taxable year, assets and net investment income that are not intended or available for the use or benefit of the institution are not to be taken into account by that educational institution.

Under section 4968(d)(2), the term ''related organization'' means, with respect to an educational institution, any organization that (1) Controls the educational institution; (2) is controlled by the educational institution; (3) is controlled by one or more persons that also control the educational institution; (4) is a supported organization (as defined in section 509(f)(3)) with respect to the educational institution during the taxable year; or (5) is a supporting organization (as described in section 509(a)(3)) with respect to the educational institution during the taxable year.

The first three categories of related organizations require control of an organization, but the statute does not define the term ''control.'' Furthermore, whether the educational institution is the controlling or controlled entity matters because, if the related organization controls the educational institution, or is controlled by one or more persons that also control the educational institution, then assets and net investment income of the related organization that are not intended or available for the use or benefit of the educational institution are not taken into account. In contrast, if a related organization is controlled by an educational institution, then all the assets and net investment income of the related organization are taken into account by the educational institution.

Specifically, the proposed regulations defined control as: (1) In the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of the corporation; (2) in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership; (3) in the case of a trust with beneficial interests, ownership of more than 50 percent of the beneficial interests in the trust; or (4) in the case of a nonprofit organization or other organization without owners or persons having beneficial interests (nonstock organization), including a governmental entity, (a) more than 50 percent of the directors or trustees of the educational institution or nonstock organization are either representatives of, or are directly or indirectly controlled by, the other entity or (b) more than 50 percent of the directors or trustees of the nonstock organization are either representatives of, or are directly or indirectly controlled by, one or more persons that control the educational institution.

The commenters sought clarifications and modifications of how related organizations are treated based around three major issues: (1) Control, (2) potential double taxation of certain types of related organizations, and (3) treatment of the assets of certain related organizations.

a. Control

Commenters stated generally that use of the proposed definition of ''control'' would result in educational institutions' being required to take into account assets and net investment income that the educational institutions do not actually control and that they will never receive because the assets and income actually belong to unrelated third parties. The commenters also stated that such a rule is inconsistent with Congressional intent, and would not address Congressional concerns that educational institutions might attempt to avoid the section 4968 excise tax by holding assets in structures that, as compared to direct ownership, represent a difference in form but not substance.

The final regulations provide separate rules for the different relationships that may exist and separately define control for organizations that (1) control an educational institution, (2) are controlled by an educational institution, and (3) are controlled by one or more persons that also control an educational institution.

b. Double Taxation of Certain Related Organizations

Even if an educational institution controls certain types of related organizations, subjecting the assets or net investment income of these organizations to the section 4968 tax might result in double or triple taxation. In applying the related organization provisions of section 4968(d), commenters recommended disregarding taxable corporations and trusts, partnerships and pass-through entities, and split-interest trusts.

Several types of entities that might be related organizations are taxed and then provide after-tax dollars to the educational institution. Counting these distributions toward the section 4968 tax might result in double taxation. The Treasury Department and the IRS do not consider it consistent with Congressional intent to tax the income again under section 4968. These final regulations exclude from the definition of ''related organization'' a taxable corporation and certain taxable trusts, in each case whether foreign or domestic.

To prevent double taxation of a partnership's net investment income and overcounting of its assets, these final regulations exclude from the definition of ''related organization'' a partnership, S corporation, or other pass-through entity a portion of whose income flows through to the educational institution.

c. Treatment of Assets of Certain Related Organizations

i. Trusts

With respect to trusts, commenters raised issues concerning ''control'' and whether charitable remainder trusts should be counted as an asset of the educational institution, even if the educational institution is deemed to control the trust. Several commenters stated that the proposed rule for control of trusts, which provided that control of a trust with beneficial interests means ownership of more than 50 percent of the beneficial interests in the trust, would not lead an educational institution to control the trust within the generally accepted meaning of that term. Commenters stated that the trustee of a trust does not control a trust in a way that is relevant for purposes of section 4968, because the trustee is required to administer the trust in accordance with, and to the extent of the trustee's duties and powers as determined by, the terms of the trust and applicable law.

The Treasury Department and the IRS acknowledge that the concept of control does not mesh well with trusts. In attempting to construct a replacement for the control rule for trusts to be used in the context of section 4968, the Treasury Department and IRS identified the circumstances under which a trust should be deemed to have a relationship with the educational institution that is sufficiently similar to that generally intended by the concept of control.

These final regulations provide that a trust is a related organization, and an educational institution is deemed to control that trust, only: (1) If the educational institution is substantially the sole permissible trust beneficiary or appointee of both income and principal, whether or not the timing of distributions is subject to the trustee's discretion; (2) if the trust is a pooled income fund described in sections 642(c)(3) and 642(c)(5); (3) to the extent that the assets of the trust were contributed to the trust by the educational institution (or by a person controlled by the educational institution, as determined under these regulations); or (4) to the extent that the educational institution (or a person controlled by the educational institution, as determined under these regulations) has the right to demand (or can otherwise cause) a distribution of principal from the trust to the educational institution (or a person controlled by the educational institution). The final regulations clarify how to determine whether a person is controlled by an educational institution.

With respect to split interest and charitable remainder trusts, commenters noted that an educational institution generally is not able to receive any benefit from, and cannot use assets in the trust, until the termination of the interests of the income beneficiaries (which may be decades into the future). This is true even if the value of the educational institution's interest in the trust exceeds 50 percent of the present value of all beneficial interests in the trust. Further, commenters noted it would be difficult for an educational institution to obtain information about the income of a split-interest trust, as there is currently no federal requirement for a split-interest trust to report this information to its remainder beneficiary(ies).

With regard to charitable remainder trusts and split-interest trusts, even those that are administered by an educational institution, the Treasury Department and the IRS concluded that the assets and net investment income of such trusts should be included in the educational institution's assets and net investment income only as they are received by the educational institution. Any income from such trusts already is included in the educational institution's net investment income as it is received. A remainder interest held by an educational institution is deferred for a sometimes lengthy and sometimes indeterminate amount of time and is subject to market fluctuations that will affect (or could eliminate) the amount of any eventual distribution of principal to the educational institution.

In addition, because there are only limited circumstances in which the educational institution would have sufficient control over a trust to justify treating the trust as a related organization, the final regulations also exclude all other taxable trusts from the definition of a related organization except to the extent the educational institution is deemed to control the trust.

ii. Employee Benefit Funds

Commenters stated that various retirement and benefit plans should be excluded from the definition of related organization for purposes of section 4968(d), stating that the beneficiaries of these plans are employees of the educational institutions and it was not the intent of Congress to tax the investment income of these entities. Accordingly, these final regulations provide that an employee benefit fund is not a related organization for purposes of section 4968(d).

iii. Nonstock Organizations

One commenter objected to the proposed rule for control of nonstock organizations, stating that the portion of the rule that is based on directors or trustees of the educational institution being representatives of the other organization often incorrectly determines which entity controls the other, as the presence of common directors or trustees alone is not determinative of control.

The Treasury Department and the IRS agree that a modified version of control for nonstock organizations that is based on the power of the educational institution (or one or more of its managers, directors, officers, trustees, or employees, acting only in that capacity) to cause (or prevent) a certain act would more appropriately reflect control by the educational institution over the nonstock organization.

Thus, these final regulations provide that an educational institution controls a nonstock organization if the educational institution (or one or more of its managers, directors, officers, trustees, or employees acting only in that capacity) can (1) appoint or elect (which must include the power to remove and replace) more than 50 percent of the members of the nonstock organization's governing body (such as directors, officers, or trustees), or otherwise can appoint or elect that majority with reasonable frequency; (2) require the nonstock organization to make an expenditure (or prevent the organization from making an expenditure); or (3) require the nonstock organization to perform any act that significantly affects its operations (or prevent it from performing such an act). Such control includes control by aggregating votes or positions of authority (including by veto power) but applies regardless of the method by which the control is exercised or exercisable.

Paperwork Reduction Act

The collections of information contained in the final regulations will be submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of (1995) (44 U.S.C. 3507(d)). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

A. Collections of Information Imposed by the Regulations

The collection of information in these final regulations is in §§ 53.4968–1(b)(2), (3), (4), and (5); 53.4968–2(d)(2)(ii) and (iii); and 53.4968–3(c) and (d)(2). The collection of information for § 53.4968–1 is required to determine whether an educational institution is an applicable educational institution, as defined in section 4968(b). In particular, this collection of information includes definitions to enable educational institutions to determine what individuals constitute students of the educational institution, which students are tuition-paying, which students are located in the United States, and which assets of the educational institution are used directly in carrying out an institution's exempt purpose. The collection of information for § 53.4968–2 is required to calculate net investment income as defined in section 4968(c). In particular, this collection of information includes determining an applicable educational institution's share of gain upon the sale or other disposition of a partnership asset. The collection of information for § 53.4968–3 is required to determine the assets and net investment income of related organizations that are treated as assets and net investment income of applicable educational institutions, as defined in section 4968(d). In particular, this collection of information includes whether an organization is a supporting organization (as described in section 509(a)(3) of the Code) with respect to such institution (including whether the supporting organization is a Type I, Type II, or Type III), whether the related organization supports more than one educational institution, and determining the assets and net investment income of a related organization that are attributed to the educational institution.

The excise tax for section 4968 is reported by timely filing a Form 990, Return of Organization Exempt From Income Tax, and Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code, Schedule O, Excise Tax on Net Investment Income of Private Colleges and Universities. In 2016, the IRS released and invited comments on drafts of an earlier version of Form 4720 in order to give members of the public the opportunity to benefit from certain specific amendments made to the Code. The IRS received no comments on Form 4720 during the comment period. Consequently, the IRS made Form 4720 available on December 9, 2016, for use by the public. The IRS is contemplating making additional changes to Form 4720 to accommodate new provisions provided for in the final regulations, such as for the allowance of capital loss carryovers. The IRS intends that the burden of the collections of information will be reflected in the burden associated with Form 4720, OMB approval number 1545–0047.

B. Burden Estimates

The burden associated with Form 4720 is included in the aggregated burden estimates for OMB control number 1545–0047. The burden estimates in 1545–0047 relate to all filers associated with the Forms 990 and 4720, and will in the future include, but not isolate, the estimated burden of the information collections associated with these final regulations.

The expected burden estimates for this final rule are based on the information that is available to the IRS, and have been updated from the proposed regulations to include new provisions provided in the final regulations that reduce the record keeping burden for the private colleges and universities that are subject to the tax under section 4968. The final regulations clarify that an educational institution may use any reasonable method for determining whether a student is located in the United States as long as that method is consistently applied, and that the educational institution may use any reasonable method to determine the reasonable cash balance necessary to cover current operating expenses, providing an example of a reasonable method. The final regulations also exclude several items of income from the definition of gross investment income, such as interest income from certain student loans, rental income from the provision of certain housing to students, faculty, and staff, and certain royalty income. The final regulations further disregard from the calculation of capital gains any gain from the sale or exchange of the portion of property that is used by an applicable educational institution for its exempt purpose and any appreciation in the value of donated property that occurred prior to the date of its donation. The final regulations provide an easier method for applicable educational institutions to substantiate interests and assets in partnership holdings. Finally, the final regulations exclude several types of organizations from the definition of "related" and adjust the definition of control for purposes of determining when an organization is related for purposes of section 4968.

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

Estimated number of respondents: 40.

Estimated average annual burden hours per response: 10 hours, 7 minutes.

Estimated total annual burden: $39,026 ($2017).

Estimated frequency of collection: Annual.

Accordingly, the new provisions in the final regulations reduced the estimated average annual burden hours per response by 22 hours, 20 min, and the estimated total annual burden by $84,310 from the burdens estimated in the proposed regulations, which provided for an estimated 40 number of participants, 32 hours and 27 minutes average burden hours per response, and $123,336 (2017) total annual burden.

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

Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. In the proposed regulations, the Treasury Department and the IRS invited comments on the impact this rule may have on small entities. The Treasury Department and the IRS did not receive any comments on this issue. As discussed elsewhere in this preamble, this rule merely provides definitions regarding the applicability of the section 4968 excise tax to certain private colleges and universities and rules for calculating any tax that might be imposed. The requirements in this regulation fall only on educational institutions whose non-exempt assets have an aggregate fair market value of at least $500,000 per student of the institution and that have at least 500 tuition-paying students (for a minimum investment asset value of $250,000,000).

The threshold established by the Small Business Administration for an educational institution to be considered a small entity is income from all sources exceeding $27.5 million. This final rule will not affect a substantial number of small entities. Only about 1.7 percent of four-year colleges and universities (less than 40 out of over 2,400 institutions in the National Center for Education Statistics' Integrated Post-Secondary Education System Data for 2016) are expected to be affected by the tax. This is because at a modest 4 percent rate of return, the minimum endowment alone would generate income of $10 million. To generate another $17.5 million in income would require receipts of $35,000 per student if the institution had only the minimum number of students, compared to average tuition and fees at a four-year private college or university, which was $39,529 in 2015–16. Accordingly, the Secretary certifies that this rule will not affect a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business (84 FR 31795, July 3, 2019). No comments on the notice were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

Congressional Review Act

The Office of Management and Budget has determined that the final rule is not a ''major rule'' within the meaning of the Congressional Review Act (5 U.S.C. 801, *et seq.*).

Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The final regulations do not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The final regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Drafting Information

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

Statement of Availability of IRS Documents

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

List of Subjects in 26 CFR Part 53

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

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 53 is amended as follows:

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

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

Authority: 26 U.S.C. 7805.

* * * * *

■ **Par. 2.** Sections 53.4968–1 through 53.4968–4 are added to subpart K to read as follows:

Sec.

53.4968–1 Excise tax based on investment income of certain private colleges and universities.
53.4968–2 Net investment income.
53.4968–3 Related organizations.
53.4968–4 Applicability date.

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

(a) *Excise tax on the investment income of certain private colleges and universities.* For taxable years beginning after December 31, 2017, section 4968 of the Internal Revenue Code (Code) imposes a tax equal to 1.4 percent of the net investment income (as defined in section 4968(c) and § 53.4968–2) of an applicable educational institution (as defined in section 4968(b)(1) and paragraph (b)(1) of this section).

(b) *Definitions.* The definitions in this paragraph (b) apply for purposes of section 4968 and §§ 53.4968–1 through 53.4968–4.

(1) *Applicable educational institution.* The term *applicable educational institution* means any eligible educational institution (as defined in section 25A(f)(2) of the Code and § 1.25A–2(b) of this chapter)—

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

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

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

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

(2) *Student.* The term *student* means a person who is enrolled and attending a course for academic credit from the institution and who is being charged tuition at a rate that is commensurate with the tuition rate charged to students enrolled for a degree. The number of students of an educational institution (including for purposes of determining the number of students at a particular location) is based on the daily average number of full-time students (with part-time students taken into account on a full-time student equivalent basis). The standards for determining part-time students, full-time students, full-time equivalents, and daily average are determined by each educational institution. However, the standards may not be lower than the minimum applicable standards established by the Department of Education under the Higher Education Act of 1965 (20 U.S.C. 1088), as amended.

(3) *Tuition-paying*—(i) *In general.* The term *tuition-paying* means the payment of any tuition or fees required for the enrollment or attendance of a student for a course of instruction at an educational institution. Tuition and fees do not include payment for supplies or equipment required during a specific course once a student is enrolled in and attending the course, or payment for room and board or other personal living expenses.

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

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

(4) *Located in the United States.* A student is *located in the United States* if the student resided in the United States for at least a portion of the time the student attended the educational institution during the institution's preceding taxable year. Whether a student resided in the United States in any given year can be determined using any reasonable method, as long as that method is consistently applied.

(5) *Assets used directly in carrying out an institution's exempt purpose*—(i) *In general.* Except as provided in paragraph (b)(5)(iv) of this section, an asset is *used directly in carrying out an educational institution's exempt purpose* only if the asset is actually used directly by the institution in carrying out its exempt purpose. Whether an asset is used directly by the institution to carry out its exempt purpose is determined based on all the facts and circumstances. If property is used for an exempt purpose and for other purposes, and the exempt use represents 95 percent or more of the total use, the property is considered to be used exclusively for an exempt purpose. If the exempt use of such property represents less than 95 percent of the total use, the institution must make a reasonable allocation between such exempt and nonexempt uses.

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

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

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

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

(D) The reasonable cash balance, determined using any reasonable method, necessary to cover current operating and administrative expenses and other normal and current disbursements directly connected with the educational institution's exempt activities. For this purpose, a reasonable method would include calculating an amount equal to three months of operating expenses allocable to program services, calculated by dividing annual functional expenses allocable to program services by four. A larger amount may be a reasonable cash balance for this purpose if, under the facts and circumstances, a larger amount is established to be necessary to cover administrative expenses and other normal disbursements directly connected with the institution's exempt activity.

(E) Any property the educational institution leases to other persons at no cost (or at a nominal rent) to the lessee in furtherance of the institution's exempt purposes; and

(F) Patents, copyrights, and other intellectual property and intangible property to the extent that income from those assets is excluded from net investment income by § 53.4968–2(b)(2)(iii).

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

(A) Assets that are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or leased real estate not described in paragraph (b)(5)(ii)(E) of this section), even if the income from such assets is used to carry out such exempt purpose; and

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

(iv) *Assets of related organizations.* An asset of a related organization that is treated as an asset of an educational institution by section 4968(d) and § 53.4968–3(c) and that is used directly in carrying out an educational institution's exempt purpose, or that is used directly in carrying out the exempt purpose of a related organization that is described in section 501(c)(3), is considered used directly by the educational institution in carrying out its exempt purpose.

(v) *Valuation of assets not used directly in carrying out an institution's exempt purpose*—(A) *In general.* The values of assets not used directly in carrying out an educational institution's exempt purpose are determined under the rules of section 4942(e) and § 53.4942(a)–2(c)(4), as modified by paragraph (b)(5)(v)(B) of this section.

(B) *Modifications.* In applying the rules of § 53.4942(a)–2(c)(4), an educational institution must—

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

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

§ 53.4968–2 Net investment income.

(a) *Net investment income*—(1) *In general.* For taxable years beginning after December 31, 2017, section 4968(a) of the Internal Revenue Code (Code) imposes a 1.4 percent excise tax on the net investment income (as defined in section 4968(c) and this section) of an applicable educational institution and on certain amounts of net investment income of certain related organizations, as described in section 4968(d) and § 53.4968–3. For purposes of this section, net investment income is determined under rules similar to the rules of section 4940(c) of the Code. Thus, net investment income generally is the amount by which the sum of the gross investment income (as defined in paragraph (b) of this section) and the capital gain net income (as defined in paragraph (d) of this section) exceeds the deductions allowed by paragraph (c) of this section. Except to the extent inconsistent with the provisions of this section, net investment income is determined under the principles of subtitle A of the Code.

(2) *Tax-exempt income.* For purposes of this section, net investment income is determined by applying section 103 of the Code (relating to State and local bonds) and section 265 of the Code (relating to expenses and interest relating to tax-exempt income).

(b) *Gross investment income*—(1) *In general.* For purposes of this section and except as provided in paragraph (b)(2) of this section, the term *gross investment income* means the gross amounts of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5) of the Code), and royalties, but not including any such income to the extent included in computing the tax imposed by section 511 of the Code. Such term also includes income from sources similar to those in the preceding sentence. In general, gross investment income includes the items of investment income described in § 1.512(b)–1(a) of this chapter.

(2) *Exceptions.* The following items of income are excluded from the definition of gross investment income:

(i) Interest income from a student loan that was made by the applicable educational institution or a related organization to a student of the applicable educational institution in connection with the student's attendance at the institution;

(ii) Rental income from the provision of housing by the applicable educational institution or a related organization to students of the applicable educational institution and from housing for faculty and staff if the housing is provided contingent on their roles as faculty or staff of the applicable educational institution; and

(iii) Royalty income that is derived from patents, copyrights, and other intellectual property and intangible property to the extent those assets resulted from the work of student(s) or faculty member(s) in their capacities as such with the applicable educational institution. However, neither royalty income from trademarks on the institution's logo or name nor royalty income from intellectual property donated or sold to the institution is excluded from gross investment income under this rule.

(c) *Deductions*—(1) *In general.* For purposes of computing net investment income—

(i) There is allowed as a deduction from gross investment income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications set forth in paragraph (c)(2) of this section. Taxes paid or incurred under section 4968 are not paid or incurred for the production or collection of gross investment income. Allowable expenses include that portion of an applicable educational institution's operating expenses that is paid or incurred for the production or collection of gross investment income. An applicable educational institution's operating expenses include compensation of officers, other salaries and wages of employees, outside professional fees, interest, and rent and taxes on property used in the applicable educational institution's operations. Where an applicable educational institution's officers or employees engage in activities on behalf of the institution for both activities that generate net investment income and for activities that do not generate net investment income, compensation and salaries paid to such officers or employees must be allocated between the activities that generate net investment income and for activities that do not generate net investment income.

(ii) Where only a portion of property produces, or is held for the production of, income subject to the section 4968 excise tax, and the remainder of the property is used for other purposes, the deductions allowed by this paragraph must be apportioned between the taxable and other uses.

(iii) No amount is allowable as a deduction under this section to the extent it is paid or incurred for purposes other than those described in paragraph (c)(1)(i) of this section. Thus, for example, the charitable deductions prescribed under sections 170 and 642(c) of the Code; the net operating loss deduction prescribed under section 172; and the special deductions prescribed under part VIII of subchapter B of chapter 1 of the Code are not allowable.

(2) *Deduction modifications.* The following modifications must be made in determining deductions otherwise allowable under this paragraph (c):

(i) The depreciation deduction is allowed, but only on the basis of the straight-line method provided in section 168(b)(3) and without regard to section 168(b)(1) and (2).

(ii) The depletion deduction is allowed, but such deduction is determined without regard to sections 613 and 613A of the Code, relating to percentage depletion.

(iii) The basis to be used for purposes of the deduction allowed for depreciation or depletion is the basis determined under the rules of part II of subchapter O of chapter 1 of the Code (part II of subchapter O), subject to the modifications found in paragraphs (c)(2)(i) and (ii) of this section (relating to depreciation and depletion), and without regard to § 53.4968–2(d)(2) (relating to the basis for determining gain for property held on December 31, 2017, and continuously thereafter to the date of disposition), or section 362(c) of the Code (relating to certain special basis rules regarding contributions of capital to corporations). Thus, an applicable educational institution must reduce the cost or other substituted or transferred basis by an amount equal to the straight-line depreciation or cost depletion, without regard to whether the applicable educational institution deducted such depreciation or depletion during the period prior to its first taxable year beginning after December 31, 2017. However, where an applicable educational institution has previously taken depreciation or depletion deductions in excess of the amount which would have been taken had the straight-line or cost method been employed, such excess depreciation or depletion also is taken into account to reduce basis. If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to the applicable educational institution, then the original basis to the applicable educational institution of such property is determined under the rules of § 1.1015–1(a)(3) of this chapter.

(iv) The deduction for expenses paid or incurred in any taxable year for the production of gross investment income earned as an incident to a charitable function can be no greater than the income earned from such function which is includible as gross investment income for such year. For example, where rental income incidentally is realized in a year from historic buildings held open to the public, deductions for amounts paid or incurred in that year for the production of such income is limited to the amount of rental income includible as gross investment income for the year.

(d) *Capital gains and losses*—(1) *In general.* In determining capital gain net income for purposes of the tax imposed by section 4968—

(i) *Interaction with section 511.* No gain or loss from the sale or other disposition of property is taken into account to the extent that such gain or loss is taken into account for purposes of computing the tax imposed by section 511.

(ii) *Sales or other dispositions of exempt use property.* To the extent that property is used by the educational institution for its exempt purposes, capital gain from the sale or exchange of the portion of that property that is used by the educational institution for its exempt purposes is disregarded;

(iii) *Sales of donated property*—(A) *In general.* Any appreciation in the value of donated property that occurred prior to the date of its donation to the institution is disregarded.

(B) *Date of donation.* The date of donation is determined under the timing rules of § 1.170A–1(b) of this chapter.

(C) *Value on the date of donation.* The value of the donated property on the date of donation is determined under the valuation rules of § 1.170A–1(c) of this chapter; and

(iv) *Capital losses.* Net losses from sales or other dispositions of property by one related organization (or by the applicable educational institution) reduce (but not below zero) net gains from such sales or other dispositions by other related organizations (or by the applicable educational institution). Should overall net losses from sales or other dispositions of property exceed gains from sales or other dispositions of such property during the same taxable year, such excess may not be deducted from gross investment income in any taxable year, nor may such excess be used to reduce gains in prior taxable years. However, capital loss carryovers are allowed and may be deducted from capital gains in a future year.

(2) *Basis*—(i) *For purposes of calculating gain from the sale or other disposition of property other than a partnership interest.* Subject to the modifications of paragraphs (c)(2)(i) and (ii) of this section (referring to the modifications relating to deductions against gross investment income) and without regard to section 362(c), the basis for purposes of determining gain from the sale or other disposition of property (other than a partnership interest) for purposes of determining capital gain net income for purposes of the tax imposed by section 4968 is the greater of—

(A) Fair market value on December 31, 2017, plus or minus all adjustments after December 31, 2017, and before the date of disposition under the rules of part II of subchapter O, provided that the property was held by the applicable educational institution on December 31, 2017, and continuously thereafter to the date of disposition, or

(B) Basis as determined under the rules of part II of subchapter O.

(ii) *For purposes of determining a distributive share of gain from the sale or other disposition of a partnership asset.* For purposes of determining an applicable educational institution's share of gain upon the sale or other disposition of a partnership asset, the applicable educational institution's basis in each such partnership asset generally is determined under the rules of subchapter K of chapter 1 of the Code (subchapter K). However, see paragraph (d)(3) of this section.

(iii) *For purposes of determining gain on the sale or other disposition of a partnership interest.* For purposes of determining an applicable educational institution's gain upon the sale or other disposition of all or a portion of a partnership interest, the applicable educational institution's basis in such partnership interest is generally determined under the rules of subchapter K, subject to the special rules in paragraph (d)(3) of this section.

(iv) *For purposes of calculating loss.* Subject to the modifications of paragraphs (c)(2)(i) and (ii) of this section (referring to the modifications relating to deductions against gross investment income) and without regard to section 362(c), basis as determined in paragraph (d)(2)(i)(B) of this section applies for purposes of determining loss. For purposes of determining loss from the sale or other disposition of a partnership interest, basis is determined under the rules of subchapter K.

(3) *Special rules regarding partnership interests and partnership assets*—(i) *Reduction of distributive share of capital gain net income from a partnership.* For purposes of computing net investment income, an applicable educational institution reduces the amount of its distributive share of capital gain net income from a partnership by the least of—

(A) The applicable educational institution's share of applicable capital gain (as defined in paragraph (d)(3)(iii)(A) of this section) from such partnership;

(B) One-third of the applicable educational institution's unadjusted step-up (as defined in paragraph (d)(3)(iii)(B) of this section) for such partnership; or

(C) The applicable educational institution's adjusted step-up (as defined in paragraph (d)(3)(iii)(C) of this section) for such partnership.

(ii) *Reduction of capital gain net income from a sale or other disposition of all or a portion of a partnership interest.* For purposes of computing net investment income, an applicable educational institution reduces the amount of its capital gain net income upon the sale or other disposition of all or a portion of a partnership interest by an amount that bears the same relation to the applicable educational institution's adjusted step-up (as defined in paragraph (d)(3)(iii)(C) of this section) for such partnership as the fair market value of the transferred portion of the interest bears to the fair market value of the applicable educational institution's entire interest in such partnership before the sale or other disposition.

(iii) *Definitions.* For purposes of this section—

(A) *Applicable capital gain.* For an applicable educational institution's first taxable year beginning after December 31, 2017, the term *applicable capital gain* means an applicable educational institution's share of both short-term and long-term capital gains and losses subject to section 4968 from a partnership. For subsequent taxable years, applicable capital gain does not include an applicable educational institution's share of short-term capital gains and losses subject to section 4968 from a partnership. For purposes of this paragraph, applicable capital gain is not less than zero.

(B) *Unadjusted step-up.* An applicable educational institution computes an *unadjusted step-up* for each partnership interest it held on December 31, 2017. The unadjusted step-up for a partnership interest equals the excess, if any, of the fair market value of such partnership interest on December 31, 2017, over the adjusted basis of such partnership interest on December 31, 2017.

(C) *Adjusted step-up.* An applicable educational institution computes an *adjusted step-up* for each partnership interest it held on December 31, 2017. The adjusted step-up for a partnership interest equals the unadjusted step-up for such partnership, reduced by the amount of any capital gain net income reduction pursuant to paragraphs (d)(3)(i) and (ii) of this section for such partnership.

(4) *Examples.* The following examples illustrate paragraph (d)(3) of this section. Unless stated otherwise in the examples, partners have no tax items other than those listed in the example. With respect to partnerships, all allocations are in accordance with section 704(b) and the regulations under section 704(b) in part 1 of this chapter (Income Tax Regulations).

(i) *Example 1*—(A) *Facts.* University (U), an applicable educational institution, is a partner in partnership PRS. On December 31, 2017, U's PRS interest had a fair market value of $130 and tax basis of $100. In 2018, U's share of capital gain net income from PRS is $5, which is comprised of $20 of gain from the sale of capital asset X and ($15) of loss from the sale of capital asset Y. Further, such $5 of capital gain net income is applicable capital gain (as defined in paragraph (d)(3)(iii)(A) of this section).

(B) *Analysis.* U has an unadjusted step-up (as defined in paragraph (d)(3)(iii)(B) of this section) for PRS of $30 ($130 fair market value − $100 tax basis on December 31, 2017). Pursuant to paragraph (d)(3)(i) of this section, for purposes of computing its net investment income, U reduces the amount of its capital gain net income from PRS by $5, which is the least of: U's share of applicable capital gain from PRS ($5); or one-third of U's unadjusted step-up for PRS ($10); or U's adjusted step-up for PRS ($30). Thus, U reduces its $5 of capital gain net income allocated from PRS by $5, resulting in U having $0 of capital gain net income in 2018 for purposes of section 4968. As a result, U's adjusted step-up for PRS for subsequent taxable years is reduced to $25 ($30 − $5) pursuant to paragraph (d)(4)(iii)(C) of this section. Pursuant to section 705, the $5 of gain allocated to U increases U's tax basis in its PRS interest to $105.

(ii) *Example 2*—(A) *Facts.* The facts are the same as in paragraph (d)(4)(i)(A) of this section (Example 1). In 2019, U sells its entire interest in PRS for $130, which, immediately prior to the sale, had a tax basis of $105. As a result, U has $25 of capital gain from the sale of its PRS interest.

(B) *Analysis.* Pursuant to paragraph (d)(3)(iii) of this section, for purposes of computing its net investment income, U reduces its capital gain net income resulting from the sale of its entire PRS interest by $25, which is the amount that bears the same relation to U's adjusted step-up for PRS ($25) as the fair market value of the transferred portion of PRS ($130) bears to the fair market value of the U's entire interest in PRS before the sale or other disposition ($130). Thus, U reduces its $25 of capital gain net income from the sale of its PRS interest by $25, resulting in U having $0 of capital gain net income in 2019 for purposes of section 4968.

(iii) *Example 3*—(A) *Facts.* The facts are the same as in paragraph (d)(4)(i)(A) of this section (Example 1). In 2019, U's share of capital gain net income from PRS is $15, which is comprised of $15 of gain from the sale of capital asset Z. Further, such $15 of capital gain net income is applicable capital gain (as defined in paragraph (d)(3)(iii)(A) of this section).

(B) *Analysis.* Pursuant to paragraph (d)(3)(i) of this section, for purposes of computing its net investment income, U reduces the amount of its capital gain net income from PRS by $10, which is the least of: U's share of applicable capital gain from PRS ($15); or one-third of U's unadjusted step-up for PRS ($10); or U's adjusted step-up for PRS ($25, computed as $30 of unadjusted step-up, less $5 of capital gain net income reduced in 2018 pursuant to paragraph (d)(3)(i) of this section). Thus, U reduces its $15 of capital gain net income allocated from PRS by $10, resulting in U having $5 of capital gain net income in 2019 for purposes of section 4968. As a result, U's adjusted step-up for PRS is reduced for subsequent taxable years to $15 ($25 − $10) pursuant to paragraph (d)(3)(iii)(C) of this section. Pursuant to section 705, the $15 of gain allocated to U increases U's tax basis in its PRS interest to $120.

§ 53.4968–3 Related organizations.

(a) *Definition of related organization*—(1) *In general.* For purposes of section 4968(d) of the Internal Revenue Code (Code) and §§ 53.4968–1 through 53.4968–4, except as provided in paragraph (a)(2) of this section, the term *related organization* means, with respect to an educational institution, any organization that—

(i) Controls such institution;

(ii) Is controlled by such institution;

(iii) Is controlled by one or more persons that also control such institution;

(iv) Is a supported organization (as defined in section 509(f)(3) of the Code) with respect to such institution during the taxable year; or

(v) Is a supporting organization (as described in section 509(a)(3)) with respect to such institution during the taxable year.

(2) *Organizations not considered related organizations.* For purposes of section 4968(d) and §§ 53.4968–1 through 53.4968–4, the term *related organization* does not include any organization that is—

(i) A taxable corporation;

(ii) A taxable trust, including a non-grantor charitable lead trust (except to the extent the trust is controlled by the educational institution as described in paragraph (b)(2)(ii) of this section);

(iii) A grantor charitable lead trust;

(iv) A charitable remainder trust;

(v) A partnership, S corporation (as defined in section 1361(a)(1) of the Code), or other pass-through entity that is generally not subject to Federal income tax, the income of which is taxable to its partners or other interest holders; or

(vi) A decedent's estate.

(3) *Employee benefit plans or arrangements.* A trust or similar funding vehicle of an employee benefit plan or arrangement, such as a section 501(a) trust funding a section 401(a) qualified retirement plan, or an annuity contract funding a section 403(b) plan, or a section 419(e) welfare benefit fund

(including a voluntary employees' beneficiary association under section 501(c)(9)) funding a welfare benefit plan, will not be treated as a related organization and its assets will not be treated as the assets of the educational institution or of a related organization. A trust or other funding vehicle of an unfunded employee benefit plan of an educational institution or a related organization, such as a grantor trust described in section 671 *et seq.,* used in connection with a section 457(b) plan or an arrangement subject to section 457(f), will be treated as a related organization for purposes of section 4968(d) and its assets will be treated as the assets of the educational institution or of a related organization, but the assets are not considered "used directly in carrying out the institution's exempt purpose" for purposes of section 4968(b)(1)(D). For purposes of determining whether the employee benefit plan of an educational institution is funded or unfunded, the educational institution and all of its related organizations are treated as a single sponsor and payor of the benefits.

(b) *Control*—(1) *Controls such institution.* For purposes of section 4968(d) and §§ 53.4968–1 through 53.4968–4, an organization controls an educational institution if—

(i) The organization owns (by vote or value) more than 50 percent of the voting and non-voting stock or membership interest of the educational institution; or

(ii) The organization (or one or more of its managers, directors, officers, trustees, or employees, acting only in those capacities) can—

(A) Appoint or elect (which must include the power to remove and replace) more than 50 percent of the members of the educational institution's governing body (such as directors, officers, or trustees), or otherwise has the ongoing power to appoint or elect more than 50 percent of such members with reasonable frequency;

(B) Require the educational institution to make an expenditure (or prevent the educational institution from making an expenditure); or

(C) Require the educational institution to perform any act that significantly affects its operations (or prevent it from performing such an act).

(2) *Is controlled by such institution.* For purposes of section 4968(d) and §§ 53.4968–1 through 53.4968–4, an organization is controlled by an educational institution:

(i) *Tax-exempt corporation.* In the case of a corporation recognized as exempt from income tax under section 501(a), if the educational institution owns (by vote or value) more than 50 percent of the voting and nonvoting stock or membership interest of the corporation.

(ii) *Trust*—(A) *In general.* In the case of a trust—

(*1*) If the educational institution is substantially the sole permissible trust beneficiary or appointee of both income and principal, whether or not the timing of the distribution is subject to the trustee's discretion;

(*2*) If the trust is a pooled income fund described in sections 642(c)(3) and 642(c)(5);

(*3*) If, but only to the extent that, the assets of the trust were contributed to the trust by the educational institution (or by a person controlled by the educational institution); or

(*4*) If, but only to the extent that, the educational institution (or person controlled by the educational institution) has the right to demand (or can otherwise cause) a distribution of principal from the trust to the educational institution (or a person controlled by the educational institution).

(B) *Person controlled by the educational organization.* For purposes of this paragraph (b)(2)(ii), a person is controlled by an educational institution if the educational institution has the power to remove and replace such person or otherwise controls the person under one of the tests described in § 53.4968–3(b)(2)(i), (ii), or (iii), with similar principles applying for purposes of determining control of any other form of entity.

(iii) *Nonstock organization.* In the case of a nonstock organization, if the educational institution (or one or more of its managers, directors, officers, trustees, or employees, acting only in those capacities) can—

(A) Appoint or elect (which must include the power to remove and replace) more than 50 percent of the members of the organization's governing body (such as directors, officers, or trustees), or otherwise has an ongoing power to appoint or elect more than 50 percent of such members with reasonable frequency);

(B) Require the organization to make an expenditure (or prevent the organization from making an expenditure); or

(C) Require the organization to perform any act that significantly affects its operations (or prevent it from performing such an act).

(3) *Is controlled by one or more persons that also control such institution.* For purposes of section 4968(d) and this section, an organization (other than one described in paragraph (a)(2) of this section) is controlled by one or more persons that also control the educational institution if more than 50 percent of the members of the governing body of the other organization are directly or indirectly controlled by persons that comprise more than 50 percent of the members of the governing body of the educational institution.

(4) *Constructive ownership.* The principles of section 318(a)(2) (relating to ownership attribution from partnerships, estates, trusts, and corporations) apply for purposes of determining ownership of stock in a corporation, and similar principles apply for purposes of determining ownership of an interest in any other entity.

(5) *Method of control.* Control includes control by aggregating votes or positions of authority (including by veto power), but applies regardless of the method by which the control is exercised or exercisable.

(c) *Organization described in section 509(a)(3) during the taxable year with respect to the educational institution.* A section 509(a)(3) organization is a supporting organization with respect to an educational institution only if the supporting organization meets the organizational, operational, and relationship tests of section 509(a)(3)(B) and § 1.509(a)–4 of this chapter with respect to the educational institution.

(d) *Assets and net investment income of related organizations*—(1) *In general.* A related organization's assets and net investment income are taken into account both in determining whether an institution is an applicable educational institution and in computing the net investment income of an applicable educational institution. For purposes of determining the aggregate fair market value of the assets and net investment income of an educational institution, the assets and net investment income of all related organizations are treated as the assets and net investment income, respectively, of the institution, unless an exception provided in paragraph (d)(2) of this section or the exception provided in § 53.4968–1(b)(5)(iv) (relating to assets used directly in carrying out an exempt purpose) applies. In cases in which an organization is a related organization with respect to an educational institution under more than one definition of this § 53.4968–3, then the rule that attributes the largest amount of assets and net investment income of the related organization to the educational institution must be applied.

(2) *Exceptions.* For purposes of section 4968 and this paragraph (d)(2)—

(i) *No amount is taken into account with respect to more than one educational institution.* In determining the aggregate fair market value of the assets and net investment income of an educational institution, assets and net investment income of a related organization are not taken into account with respect to more than one educational institution. Thus, in any case in which an organization is a related organization with respect to more than one educational institution, the assets and net investment income of the related organization must be allocated between or among the educational institutions as to which the organization is a related organization, subject to paragraph (d)(2)(ii) of this section. The educational institution must make such allocation in a reasonable manner, taking into account all facts and circumstances, that is consistent across all related organizations.

(ii) *Assets and net investment income that are not intended or available for the use or benefit of the educational institution*—(A) *In general.* Unless a related organization is controlled by the educational institution or is a supporting organization described in section 509(a)(3) with respect to such institution for the taxable year, assets and net investment income of a related organization that are not intended or available for the use or benefit of the educational institution are not taken into account by that educational institution.

(B) *Determining whether assets and net investment income of a related organization are intended or available for the use or benefit of an educational institution.* If a related organization controls the educational institution, is controlled by one or more persons that also control such institution (but is not described in section 509(a)(3) with respect to the educational institution for the taxable year), or is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the educational institution, then the related organization's assets and net investment income are taken into account as assets and net investment income of the educational institution only to the extent the assets and net investment income are intended or available for the use or benefit of that educational institution. Assets and net investment income of a related organization are intended or available for the use or benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for the benefit of, or otherwise are fairly attributable to, the educational institution. For example, assets are fairly attributable to the educational institution if they have been affirmatively designated or appropriated for the educational institution or made available for the educational institution to draw upon at will. Conversely, assets and net investment income of a related organization are not intended or available for the use or 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 are not fairly attributable to the educational institution. The assets and net investment income of a related organization must be allocated between those intended or available for the use or benefit of an educational institution and those not intended or not available for the use or benefit of that same educational institution. The educational institution must make such allocation in a reasonable manner, taking into account all facts and circumstances, that is consistent across all related organizations.

(C) *Related organizations that are controlled by the educational institution or that are supporting organizations (as described in section 509(a)(3)) with respect to the educational institution during the taxable year*—(*1*) *In general.* If a related organization is controlled, as defined in paragraph (b)(2) of this section, by an educational institution, or is a supporting organization with respect to the educational institution during the taxable year, as defined in paragraph (c) of this section, the assets and net investment income of the related organization are taken into account as assets and net investment income of the educational institution regardless of whether those assets and net investment income are earmarked or restricted for the benefit of, or otherwise are fairly attributable to, the educational institution and even if they are specifically earmarked or restricted for another entity or for unrelated purposes or otherwise are not fairly attributable to the educational institution, subject to paragraph (d)(2)(ii)(C)(*2*) of this section. However, see §§ 53.4968–1(b)(2)(ii)(A)(*3*) and (*4*) regarding trusts that are controlled related organizations only to the extent assets of the trust were contributed to the trust by the educational institution (or by a person controlled by the educational institution), or only to the extent the educational institution (or person controlled by the educational institution) has the right to demand (or can otherwise cause) a distribution of principal from the trust to the educational institution (or a person controlled by the educational institution). *See also* § 53.4968–1(b)(5)(iv) for rules relating to when assets of a related organization are deemed to be used directly in carrying out the institution's exempt purpose.

(*2*) *Special rule for Type III supporting organizations with respect to an educational institution as of December 31, 2017.* An educational institution with a related organization that was a Type III supporting organization with respect to the educational institution on December 31, 2017, takes into account only the assets and net investment income of such Type III supporting organization that are intended or available for the use or benefit of, or otherwise are fairly attributable to, the educational institution, as described in paragraph (d)(2)(ii)(B) of this section. An educational institution may determine whether the assets and net investment income of such a Type III supporting organization are intended or available for the use or benefit of, or otherwise are fairly attributable to, the educational institution using any reasonable method. A method that attributes to an educational institution assets and net investment income of a supporting organization that specifically are earmarked for the educational institution, are restricted for the benefit of the educational institution, or otherwise are fairly attributable to the educational institution (such as those that have been affirmatively designated or appropriated for the educational institution or made available for the educational institution to draw upon at will) will be deemed to be reasonable.

(3) *Determining assets of related organizations.* To determine which assets of a related organization are included by an educational institution under section 4968(b)(1)(D) for a particular year, an educational institution determines which organizations are related organizations, as defined in section 4968(d)(2) and § 53.4968–3, as of the end of the educational institution's preceding taxable year, and values the relevant assets on that date.

(4) *Determining net investment income of related organizations.* To determine the amount of net investment income of a related organization that is included by the applicable educational institution in calculating the tax imposed by section 4968(a) for a particular taxable year, an applicable educational institution determines which organizations are related organizations, as defined in section 4968(d)(2) and § 53.4968–3, as of the

end of that taxable year of the applicable educational institution and includes the net investment income from each related organization's taxable year that ends with or within that same taxable year of the applicable educational institution. If an organization became a related organization after the beginning of the applicable educational institution's taxable year, then the applicable educational institution includes the organization's net investment income for the portion of the year that the organization was a related organization, using any reasonable method.

§ 53.4968–4 Applicability date.

The rules of §§ 53.4968–1 through 53.4968–3 apply to taxable years of an educational institution beginning after October 15, 2020.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: September 4, 2020.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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