The University Excise Tax and Net Investment Income: Proposed Regulations Dodge the Hard Questions

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INTRODUCTION

Section 4968, which was added to the Code by the Tax Cuts and Jobs Act (TCJA), imposes an excise tax of 1.4% on the net investment income of certain private colleges and universities with large endowments valued at $500,000 or more per student. On June 28, 2019, the Treasury Department and the Internal Revenue Service released proposed regulations providing guidance for determining the new excise tax. The guidance was much needed, as most colleges and universities that are subject to the tax — referred to in the statute as “applicable educational institutions” (AEIs) — will have to make their first payments of §4968 excise taxes in November. Unfortunately, the proposed regulations provide these AEIs with relatively little guidance on how to calculate the tax.

Section 4968 taxes AEIs on their “net investment income” (NII) and defines NII only by stating that it “shall be determined under rules similar to the rules of section 4940(c).” Section 4940(c) defines NII for purposes of the excise tax on such income earned by private foundations. In defining NII for purposes of §4968, the proposed regulations unfortunately do little more than parrot the statute, merely cross-referencing §4940(c) and the regulations thereunder, with some minor modifications. By mostly limiting the guidance to these cross-references, the proposed regulations provide AEIs with virtually no additional guidance on the question of how to determine NII. In particular, they neglect to take into account meaningful differences between the operations of a college or university and a typical private foundation. In addition, the proposed regulations fail to recognize the many ways investment activity has changed over the nearly 50 years since the proposed regulations under §4940 were issued — in particular, the increased amount of investment activity conducted through partnerships and the issues such investments raise. Consequently, the proposed regulations raise more questions than they answer.

This article reviews what questions the proposed regulations under §4968 do and do not answer for AEIs attempting to determine their NII for the first time and highlights areas where AEIs will have to reach positions in the absence of clear guidance over the next several months.

NET INVESTMENT INCOME

Section 4940(c) and, by cross-reference, §4968, define NII as: (1) gross investment income (GII); plus

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1 All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

2 §4968(c).

3 This article does not address the requirements to be categorized as an AEI in the first place. Most of the provisions in the proposed regulations under §4968 relate to these requirements and are analyzed in IRS Issues Proposed Regulations for University Excise Tax, by Ruth M. Madrigal, Preston J. Quesenberry, and Randall S. Thomas, What’s News in Tax (July 25, 2019).
eral money, then your endowment is no longer subject to any tax dowments. . . . So the rationale is, if you choose not to take Fed-
new excise tax on the investment income of large university en-
ment of a private college or university has grown so large that
impose a modest excise tax on the investment income derived
are devoted to charitable activities." 6 While recognizing the
provisions relating to assets devoted to charitable activities ("exempt-use assets"), AEIs and practitioners 7 expected that Treasury and the IRS would use the "similar to" language in §4968(c) and Congress’s focus on "endowment" assets in enacting §4968 as authority to exclude from GII income derived from at least some such "exempt-use assets."

Gross Investment Income

Section 4940(c)(2) defines GII as the gross amount of income from interest, dividends, rents, royalties, and payments with respect to securities loans, but not including any UBTI and not including any interest earned on tax-exempt bonds. 4 Pursuant to changes made by the Pension Protection Act of 2006, §4940(c)(2) further provides that GII includes "income from sources similar to those in the preceding sentence." 5 In addition, the regulations under §4940(c) provide that GII takes into account "interest, dividends, rents, and royalties derived from assets devoted to charitable activities." 6 While recognizing the regulations’ provisions relating to assets devoted to charitable activities ("exempt-use assets"), AEIs and practitioners 7 expected that Treasury and the IRS would use the "similar to" language in §4968(c) and Congress’s focus on "endowment" assets in enacting §4968 as authority to exclude from GII income derived from at least some such "exempt-use assets."

4 Specifically, §4940(c)(5) provides that NII is determined by applying §103 (relating to state and local bonds) and §265 (relating to expenses and interest attributable to tax-exempt income).


6 Reg. §53.4940-1(d)(1).

7 See, e.g., Memo on Net Investment Income Forwarded to Treasury, 2019 Tax Notes Today 44-48 (March 6, 2019).

8 See, e.g., H.R. Rep. No. 115-409, p. 422 ("Where the endow-
ment of a private college or university has grown so large that it is not commensurate with the scope of the institution’s activities in educating students, the Committee believes it is appropriate to impose a modest excise tax on the investment income derived from the endowment."); S. Prt. 115-20, p. 273 ("Where the endow-
ment of a private college or university has grown so large that it is not commensurate with the scope of the institution’s activities in educating students, and where the significant portion of the student population does not receive scholarships, the Committee believes it is appropriate to impose a modest excise tax on the investment income derived from the endowment."); 163 Cong. Rec. H9351, H9358 ("The Tax Cuts and Jobs Act includes a 1.4 percent excise tax on private college endowments . . . . This bill adds a special tax on the endowments of colleges and universities . . . ."); 163 Cong. Rec. S7693-S7694 ("[Section 4968] imposes a new excise tax on the investment income of large university endowments . . . . So the rationale is, if you choose not to take Federal money, then your endowment is no longer subject to any tax even though the endowment money comes from people who get a deduction for the money they give, correct?"); 163 Cong. Rec. S8101 ("[C]ertain provisions of the Republican tax legislation violate the Byrd rule, including . . . . part of the criteria used to determine whether the endowments of private universities are subject to the legislation’s new excise tax.").


10 Id. In explaining why a type of income should be excluded, commenters are also asked to "state specifically how the proposed exclusion is still 'similar to' the rules of section 4940(c)."
amounts charged by a college or university related to provision of housing and meals." 11

The question about “distinguishing factors” in the preamble has many AEIs considering whether the payments they receive from students for dormitory use may be differentiated from “rents” within the meaning of §4940. Unfortunately, neither §4940 nor the regulations thereunder (much less the proposed regulations under §4968) contain any definition of the term “rents.” That said, most universities will be able to draw numerous distinctions between their dormitories and typical space that is leased for occupancy. For one, as the preamble itself suggests, student housing in dormitories provided by colleges and universities does not typically involve a lease agreement between the student and college or university. Moreover, landlord-tenant laws do not typically apply to student dormitories. In addition, students commonly receive services in connection with their dormitory use that tenants do not usually receive from landlords. This distinction might be seen as especially relevant given that the rules governing UBTI disqualify payments as “rents from real property” when the occupant receives services “other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.” 12 Further, dormitory use often has a mandatory dimension absent in typical landlord-tenant relationships. For example, some AEIs require certain students (e.g., freshman) to live on campus and assign these students dormitories and roommates. These and other distinguishing factors should matter in determining whether to classify payments for dorm rooms as “rents,” notwithstanding the lack of any definition of that term for purposes of §4940 or §4968. The uncertainty is magnified by the fact that GII includes not only “rents” but also “income from sources similar to” rents, with the meaning of “sources similar to” also undefined. Notwithstanding this uncertainty, AEIs will need to determine their position on whether payments for dorm rooms are or are not GII over the next couple of months.

Even if AEIs determine that payments for dorms are rents that have to be included in GII, this inclusion may not actually increase NII if the deductible expenses associated with the dorms equal or exceed those rents. However, making this determination for dorms and other exempt-use assets is likely to significantly increase administrative headaches, as it will require AEI tax departments to track and allocate expenses more rigorously than they may have had to do in the past.

One final thing to note about rents includible in GII is that they are not necessarily limited to rents from real property, but also may include rents from personal property. 13 As a general rule, most rents from personal property are included in UBTI, which means they would be excluded from GII on that basis. But if an AEI considers any personal property rents to not be UBTI because, for example, the rentals are substantially related to the AEI’s educational purposes (e.g., rentals of lab attire for chemistry students) or are primarily for the convenience of students or employees, those rents could still be included in GII based on the rules in the proposed regulations. Taxing AEIs on this income would be an unexpected, and arguably unintended, application of a tax that ostensibly targets the “endowment” income of AEIs.

### Capital Gain Net Income

In addition to GII, NII includes capital gain net income, which consists of capital gains less any capital losses, with no capital loss carryovers or carrybacks and no ability to use excess capital losses against GII in the same tax year. 14 Capital gain net income does not include any gain or loss taken into account in computing UBTI.

### Sale of Exempt-Use Assets

While capital gains and losses on the disposition of exempt-use assets were once excluded from NII, amendments to §4940 in 2006 15 and 2007 16 changed this, so that §4940 now applies to “capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.” 17 However, the regulations under §4940 have not been amended to reflect this change and still state 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.” 18 As the proposed regulations under §4968 cross-reference not only the regulations under §4940 but also §4940(c) for purposes of determining capital gain net income.

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11 Id.
12 Reg. §1.512(b)-1(c)(5).
13 See Historic House Museum Corp. v. Commissioner, 70 T.C. 12 (1978) (defining “rents,” for purposes of §4940, by reference to Reg. §1.61-8, which defines rents as amounts “received or accrued for the occupancy of real estate or the use of personal property”).
14 §4940(c)(4); Reg. §53.4940-1(f)(1), §53.4940-1(f)(3).
17 Joint Committee on Taxation, Technical Explanation of H.R. 4, the “Pension Protection Act of 2006,” (JCX-38-06) at 324.
18 Reg. §53.4940-1(f)(1) (also stating that “gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded.”).
and the regulations under §4940 are obviously out of date, it appears that capital gain net income may include both gain realized on the sale of investment assets and gain from the disposition of exempt-use assets. Accordingly, to the surprise of AEIs and practitioners that expected §4968 to tax investment income from endowments, the proposed regulations could tax gain from an AEI’s disposition of classroom buildings and other exempt-use assets if they are adopted without change.

Basis for Calculating Gain

To determine capital gain net income, AEIs will naturally need to know their basis in the assets they sell. More than a year ago, in Notice 2018-55, Treasury and the IRS made clear that §4968 would not tax AEIs on any appreciation in property (that is, over the property’s adjusted basis) that occurred before December 31, 2017, nine days after §4968 was enacted and the day before §4968 went into effect for calendar-year AEIs. The proposed regulations implement this basis “step-up” contemplated by Notice 2018-55 by simply cross-referencing Reg. §53.4940-1 through (f) and substituting “December 31, 2017” as the applicable date.

In making this substitution, the proposed regulations clarify several points implicitly made by Notice 2018-55. For one, by cross-referencing the regulations under §4940, the proposed regulations make clear that, for purposes of calculating capital gain under §4968, the basis of an asset will be the greater of:

- The basis as determined and adjusted under normal basis rules, modified by: (1) using the straight-line method of depreciation; (2) not using percentage depletion described in §613; and (3) without regard to §362(c) (relating to the basis for certain contributions to capital) (henceforth “Normal §4940 Basis”), or

- In the case of an asset held on December 31, 2017, and continuously thereafter until disposition, the fair market value (FMV) as of December 31, 2017 (December 31, 2017 FMV), plus or minus all adjustments after December 31, 2017, using the normal basis rules subject to the same modifications applicable in determining Normal §4940 Basis.

In addition, the cross-referencing in the proposed regulations establishes that basis “stepped up” to December 31, 2017 FMV should not be used for purposes of determining a loss. Rather, for losses, an AEI should use the Normal §4940 Basis.

Partnership Investments and Transition Issues

Although the basis step-up and other NII rules described above may have worked well for stock investments held by private foundations in 1969, AEIs, which now earn much of their NII through investment vehicles taxed as partnerships for federal income tax purposes, will encounter particular challenges in computing NII attributable to partnership investments. As a general matter, partnerships do not report their investment income to partners on Schedule K-1 in a uniform manner and often such income is aggregated in ways that will present challenges to AEIs in calculating their NII. Perhaps nowhere will these challenges be more significant than with respect to capital gain net income, though inconsistent reporting of GII and other issues will likely arise as well.

Inside vs. Outside Basis Step-Up

In the case of partnership interests owned by an AEI, Notice 2018-55 was silent regarding whether the basis step-up to December 31, 2017 FMV was limited to the AEI’s basis in its partnership interests or, rather, could also be extended to a partnership’s basis in its assets. The proposed regulations address this question by providing that if an AEI held a partnership interest (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 those assets with respect to the AEI for purposes of determining the AEI’s share of gain upon a sale or disposition of the assets is not less than the December 31, 2017 FMV plus or minus all adjustments after December 31, 2017 using the normal basis rules subject to the same modifications applicable in determining Normal §4940 Basis. The proposed regulations also state that “[t]o avail itself of this special partnership basis rule, an in-

19 Prop. Reg. §53.4968-1(b)(2), (3).
20 That is, the rules of Part II of Subchapter O of Chapter 1. See Reg. §53.4940-1(f)(2)(i)(B).
23 Percentage depletion is usually separately stated on Schedules K-1, so it should generally not be difficult for AEIs to exclude these deductions in their calculation of capital gain net income. By contrast, depreciation deductions can be buried in net amounts reported on the Schedule K-1, which may make it difficult for AEIs to determine whether such amounts take into account depreciation deductions using methods other than straight-line, which are not permitted in determining NII.
stitution must obtain documentation from the partnership to substantiate the basis used.\textsuperscript{25} While this rule was presumably intended to address AEIs’ concerns regarding inside basis in partnership assets, it presents such an amorphous standard that AEIs presumably have flexibility in determining precisely what documentation represents a reasonable attempt to comply with the substantiation requirement, especially given that a strict reading of the requirement would appear to be unadministrable. For example, even if an AEI-partner could obtain the December 31, 2017 FMV of all of the assets owned by a partnership and all lower-tier partnerships — a lofty goal in itself — the AEI would also need asset-level information annually. An AEI will typically receive a Schedule K-1 for the relevant tax year that reports only the aggregate net capital gain (or loss) on the partnership assets sold during the tax year (without indicating whether those assets were owned by the partnership on December 31, 2017), and the AEI could do nothing with only this aggregate number and the December 31, 2017 FMV of the partnership’s assets. At a minimum, the partnership would also need to inform the AEI as to which specific assets (identified so that they could be linked to a particular December 31, 2017 FMV) were sold and for what amounts. In addition, if the disposition of an asset resulted in a loss (or the Normal §4940 Basis in the asset was higher than December 31, 2017 FMV at the time of a disposition resulting in a gain), the partnership would also need to provide the AEI with the Normal §4940 Basis at the time of disposition, which may not be the same as the partnership’s own basis in the asset if the partnership was not using the straight-line method of depreciation or was taking percentage depletion.

Moreover, if any portion of the gains reported on the Schedule K-1 were UBTI, the partnership generally would (at least if the AEI were using a December 31, 2017 FMV basis for any of the sold assets) need to provide the AEI with the amount of UBTI generated by the disposition of each asset, as well as the basis of these assets at the time of the sale. This information would appear necessary for the AEI to determine what portion of the UBTI was attributable to appreciation prior to December 31, 2017 (which would presumably not be used to offset NII) and what portion was attributable to appreciation after December 31, 2017 (which could be excluded from NII).

Further, to apply the proposed regulations, the partnership would need to provide all of this information for its own assets and those of lower-tier partnerships — or provide alternative computations of capital gain specifically for the AEI based on this information — not only for 2018, but for every year thereafter until all of the assets held on December 31, 2017 are sold. In addition, most partnerships would be doing all of this additional work for at most a handful of AEIs in the absence of any provisions that require partnerships to provide this information.\textsuperscript{26} As a result, it is unclear how Treasury and the IRS can reasonably expect that AEIs would be able to obtain this information from partnerships — especially in the case of Schedules K-1 for the 2018 calendar year, most of which have already been issued.

Accordingly, in light of Congress’s intent that AEIs not be taxed on any appreciation in property that occurred before December 31, 2017, Treasury and the IRS will have to devise a more administrable rule if they expect any consistency in how AEIs step up the basis of assets held by partnerships. In the meantime, over the upcoming months, AEIs will have to determine what methodologies they are comfortable with in excluding capital gains being reported to them on Schedules K-1.

\textbf{2018 Partnership Income}

Most AEIs use a fiscal-year end of June 30 and receive Schedules K-1 from at least some calendar-year partnerships. The Schedules K-1 issued by such partnerships for 2018 covered six months for which §4968 was not in effect for fiscal-year AEIs (January 1 to June 30) and six months for which it was in effect (July 1 to December 31). Given this, some AEIs have questioned whether the NII reflected on a 2018 Schedule K-1 earned before July 1, 2018, is subject to §4968.

While the proposed regulations do not address this question, existing guidance suggests an unfavorable answer. Section 4968(a) imposes an excise tax on an AEI’s NII “for the taxable year.” Section 706(a) provides that “[i]n computing the taxable income of a partner for a taxable year, the inclusions required by section 702 and section 707(c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year.”

\textsuperscript{26}Reg. §1.6031(b)-1T generally requires a partnership to furnish to each partner a statement setting forth the partner’s distributive share of partnership income, gain, loss, deduction, or credit required to be shown on the partnership return, plus any additional information as provided by IRS forms or instructions that may be required to apply particular provisions of Subtitle A. Section 6031(d) requires that any partnership regularly carrying on a trade or business within the meaning of §512(c)(1) provide to each partner such information that will enable the partner to compute its distributive share of partnership income or loss in accordance with §512(a)(1). However, neither of these provisions appear to require a partnership to provide the information required for an AEI to compute its NII under §4968, an excise tax contained in Subtitle D.

\textsuperscript{25}Id.
year of the partnership ending within or with the taxable year of the partner.’” Reading these provisions together, an AEI most likely computes its NII for its tax year ending June 30, 2019, based on items reported for the tax year of the partnership issuing the Schedule K-1 ending within the tax year ending on June 30, 2019 — which, for a calendar-year partnership, would be the 2018 calendar year.\(^28\)

### Donated Assets

The preamble to the proposed regulations and the proposed regulations’ cross-reference to the §4940 regulations make relatively clear that when an AEI acquires an asset by gift, Treasury and the IRS are currently contemplating that the AEI’s basis will be the donor’s basis (except that if the basis is greater than the FMV of the asset at the time of the gift, then the basis will be FMV at the time of the gift for purposes of determining a loss).\(^29\) Many AEIs will not have obtained information regarding their donor’s basis in the past and may encounter difficulty obtaining it in the future. Even though individual donors who make gifts of non-cash assets to AEIs of more than $500 are required to report their basis to the IRS on Form 8283, the Form 8283 is not required to be presented to the AEI for signature for publicly traded securities, contributions of $5,000 or less, and certain other categories of assets.\(^30\) And even when a Form 8283 is provided to an AEI for signature, the donor often will not have completed the line stating the basis in the asset at the time the AEI receives the form.\(^31\) Further, the AEI may not receive the Form 8283 in time to compute its capital gain on the sale of the asset for purposes of paying and reporting NII.

The §4940 regulations cross-referenced in the proposed regulations instruct AEIs that 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 . . . then the original basis to such foundation of such property shall be determined under the rules of [Reg.] §1.1015-1(a)(3).”\(^32\) Section 1015(a) and the accompanying regulation under Reg. §1.1015-1(a)(3) contain an unusual rule that shifts the ultimate burden of determining the carryover basis in a donated asset from the donee to the IRS. In particular, these provisions state that if the donee does not know the facts necessary to determine the donor’s basis or that of the last preceding owner, it is the IRS that must, if possible, obtain the facts from the donor or last preceding owner, or any other person cognizant of such facts. If the IRS cannot obtain those facts, the donor’s basis (or that of the last preceding owner) equals the property’s FMV as determined by the IRS as of the date or approximate date at which, according to the best information that the IRS can obtain, the property was acquired by the donor (or last preceding owner).

In assessing the IRS’s responsibility under §1015(a), at least one court has made clear that if the IRS has a difficult time obtaining the necessary basis information, it cannot simply assume that basis is zero. In *James E. Caldwell & Co. v. Commissioner*,\(^33\) the U.S. Court of Appeals for the Sixth Circuit reversed the Tax Court’s holding permitting the IRS to substitute a basis of zero for purposes of determining gain on the disposition of property acquired by gift where it was ‘impossible’ to determine the FMV of the property at the time the donor acquired it. The *Caldwell* court held that if the donee cannot establish the donor’s actual basis and the IRS is unable to make a finding of FMV pursuant to the statutory mandate in §1015(a), neither gain nor loss is realized on the donee’s sale of the property.

Perhaps anticipating these difficulties, the preamble asks for comments on a potential “special rule” noted in the proposed regulations—a rule that would exclude any appreciation in a gift of donated property that occurred before the date of receipt by the AEI.\(^34\) Under this rule, the basis of any donated asset would presumably be stepped up to FMV as of the time of the gift and an AEI would only be taxed on gain generated during its ownership of an asset. The IRS also requested comments on how such a special rule would be consistent with the statutory language of §4968. The only relevant language in §4968 is that NII “shall be determined under rules similar to the rules of section 4940(c).” The law is clear that private foundations use carryover basis from donors when computing their net capital gain under §4940(c). However, AEIs are arguably distinguishable from private foundations in that they typically receive donations from many donors, while private foundations typically re-

\(^{27}\) See also Reg. §1.706-1(a).

\(^{28}\) The preamble to the final §199A regulations applies §706(a) in a similar manner: “income flowing to an individual from a partnership or S corporation is subject to the tax rates and rules in effect in the year of the individual in which the entity’s year closes, not the year in which the item actually arose.” See T.D. 9847, 84 Fed. Reg. 2,952, 2,980.

\(^{29}\) §1015; 84 Fed. Reg. 31,795, 31,800; Reg. §53.4940-1(f)(2).

\(^{30}\) See Reg. §1.170A-16(c), (d)(1), (d)(2).

\(^{31}\) See Reg. §1.170A-16(d)(5)(iii)(C) (providing that “[b]efore Form 8283 (Section B) is signed by the donee, Form 8283 (Section B) . . . is not required to contain . . . [t]he cost or other basis of the property.”).

\(^{32}\) Reg. §53.4940-1(e)(2)(iii).

\(^{33}\) 324 F.2d 660 (6th Cir. 1956).

\(^{34}\) 84 Fed. Reg. 31,795, 31,800.
ceive donations from only a handful of donors that are often intimately involved with the foundation. As a result, gathering basis information from donors will be a much more onerous task for AEIs than it would be for a private foundation.

Deductions

In General

As a general matter, the proposed regulations provide that an AEI may deduct against GII and capital gain net income all of its “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.” 35 Such expenses include depreciation, subject to several modifications. First, the straight-line method of depreciation must be used instead of accelerated depreciation methods. 36 Second, even if the AEI has not previously taken depreciation deductions with respect to depreciable property in tax years beginning before December 31, 2017, the AEI still must reduce its basis in such property by an amount equal to straight-line depreciation for purposes of taking deductions against NII in subsequent tax years. 37 Third, if the AEI has actually taken depreciation deductions in excess of the straight-line method in prior tax years (for example, against UBTI), the basis used in taking subsequent depreciation deductions must reflect this excess depreciation. 38 Finally, in contrast to the rule used for calculating capital gain (discussed above), for purposes of determining depreciation deductions, the AEI may not use a basis that has been “stepped up” to December 2017 FMV. 39 These principles apply equally to cost depletion.

Other expenses specifically mentioned in the proposed regulations (by cross-reference) as deductible against GII are the allocable portion of salaries and other compensation, outside professional fees, interest, and rents and taxes on property used. 40 Charitable contribution deductions, net operating loss deductions, and certain other statutory deductions (e.g., dividends received deductions) are specifically disallowed. 41 More generally, §4940(c)(1) states that — except to the extent inconsistent with the provisions of §4940 — NII “shall be determined under the principles of subtitle A.” This arguably suggests that deductions taken against GII and capital gain net income are limited to deductions permissible under subtitle A and that restrictions on such deductions in subtitle A — such as those under §163(j) (restricting interest deductions), §263 (disallowing deductions for certain capital expenditures), and §274 (disallowing deductions for certain entertainment and other expenses) — may also apply.

Expenses Incurred Incident to a Charitable Function

The regulations under §4940 contain a special rule for “gross investment income earned as an incident to a charitable function.” 42 This rule provides that 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 shall be no greater than the income earned from such function which is includable as gross investment income for such year.” 43 The same regulations also contain the following example illustrating this rule: “where rental income is incidentally realized in 1971 from historic buildings held open to the public, deductions for amounts paid or incurred in 1971 for the production of such income shall be limited to the amount of rental income includable as gross investment income for 1971.”

The regulations under §4940 do not define “charitable function” (or “incident to a charitable function”) for these purposes (and no authorities of which the authors are aware have expounded upon its meaning to any significant degree). The most significant authority on this rule is a TAM from 1980, in which the IRS ruled that expenses allocable to a student loan program were not deductible in calculating NII to the extent such expenses exceeded interest income from the loans. 44 In doing so, the IRS rejected the taxpayer’s argument that the phrase “incident to a charitable function” applies “only when income derived from an exempt activity is minor or inconsequential.”

No guidance exists on how broadly or narrowly a single “charitable function” should be defined and how to determine whether one or many charitable functions...

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35 §4940(c)(3)(A).
36 Reg. §53.4940-1(c)(2)(i).
37 Reg. §53.4940-1(c)(2)(iii).
38 Id.
39 Id. See also Reg. §53.4940-1(f)(4), Ex. 3; Beal Foundation v. United States, 559 F.2d 359 (5th Cir. 1977) (sustaining the validity of Reg. §53.4940-1(c)(2)(iii) and rejecting a foundation’s claim that, for purposes of determining depletion deductions, the basis of property should be “stepped up” to FMV as of December 31, 1969, as would be the case for purposes of determining capital gain).
40 Reg. §53.4940-1(e)(1)(i).
41 Reg. §53.4940-1(e)(1)(iii).
42 Reg. §53.4940-1(e)(2)(iv).
43 Id.
44 TAM 8047007.
functions exists. The issue of how to draw lines between separate “charitable functions” may not have come up previously because relatively few private foundations would have GII earned incident to a charitable function from multiple sources. AEsIs, by contrast, will almost certainly be earning such income from many sources. For example, an AEI might, in a single year, earn royalties from research patents, rents from leasing dormitories, and interest from student loans. As a result, AEsIs will need to determine where to draw the lines between GII that is incident to a charitable function and income that is not, and whether all GII from a charitable function may be aggregated along with associated expenses. If NII for each charitable function needs to be determined separately, AEsIs will need guidance on how to separate charitable functions. For example, is educating students one “charitable function,” meaning that an AEI may aggregate all GII earned and associated expenses incurred in serving that purpose? Or does an AEI need to treat each separate activity (for example, student housing v. faculty housing) or even each separate item of property (for example, each dormitory or each item of intellectual property) as a separate “function”? As Treasury and the IRS have discovered in trying to develop guidance on how to determine whether one trade or business is separate from another for purposes of another provision enacted as part of tax reform(§512(a)(6)) drawing such lines is no easy task.

Because the proposed regulations make no effort to explain how the “charitable function” limitation should apply to AEsIs’ unique circumstances, AEsIs will have to determine their NII in the absence of clear guidance on the limitation.

RELATED ORGANIZATIONS

Section 4968 provides that NII of any “related organization” of an AEI is generally to be treated as NII of the AEI.\textsuperscript{45} A related organization is defined in the statute as including any organization that controls or is controlled by the AEI, is controlled by one or more persons that control the AEI, or is a supporting or supported organization described in §509(a)(3) or §509(f)(3), respectively, of the AEI.\textsuperscript{46} As indicated by Notice 2018-55, the proposed regulations provide that overall net losses from sales or other dispositions of property by one related organization (or by the AEI) reduce (but not below zero) overall net gains from sales or other dispositions by other related organizations (or by the AEI).\textsuperscript{47}

A detailed discussion of related organizations is beyond the scope of this article, but two points in particular merit discussion: namely, whether any of the NII of taxable related organizations must be included in an AEI’s NII and the scope of the exceptions to taking into account the NII of related organizations.

Taxable Related Organizations

The proposed regulations define related organizations as including not only other nonprofit, tax-exempt organizations, but also taxable organizations. Specifically, the proposed regulations provide that an AEI “controls” (and is thus related to) a stock corporation, partnership, or trust, if it owns (either directly or indirectly by applying the principles of §318) more than 50% of the corporation’s stock (by vote or value), the partnership’s profits or capital interests, or the trust’s beneficial interests. However, taxing an AEI on the NII of a controlled taxable corporation, partnership, or non-exempt trust makes little sense for the reasons described below.

In the case of a controlled taxable corporation, any investment income earned by the corporation will already be taxed under §11 and then would be taxed again as NII if and when it is paid to the AEI as a dividend. There does not appear to be any justification for taxing it a third time as NII when it is earned by the controlled corporation.

In the case of a partnership, the AEI will already have been taxed on its proportionate share of NII derived from its partnership interests regardless of whether or not it controls the partnership. Taxing the AEI on the share of NII earned by (and, in the case of taxable partners, taxed to) other partners in the partnership just because the AEI’s profits or capital interests exceed 50% would similarly have no justification.

As for trusts in which an AEI has a beneficial interest, including charitable remainder trusts, charitable lead trusts, and other charitable trusts, it makes little sense to treat as the NII of the AEI any income that is taxed to the trust or distributed (and, in the case of taxable beneficiaries, taxed) to beneficiaries of the trust other than the AEI, regardless of whether the AEI’s beneficial interests exceed 50%.

The inequity of taxing AEsIs on the NII of taxable entities is noted in the preamble, which states that “[s]ince the net investment that a taxable entity provides to an applicable educational institution has already been taxed under section 1, the Treasury Department and the IRS do not consider it consistent with con-

\textsuperscript{45} §4968(d)(1).
\textsuperscript{46} §4968(d)(2).
\textsuperscript{47} Prop. Reg. §53.4968-1(b)(3)(v).
gressional intent to tax the income again under section 4968.\footnote{84 Fed. Reg. 31,795, 31,801.} However, the proposed regulations themselves do not provide operative language to implement this principle. In addition, the reference to \textquotedblleft section 1\textquotedblright in this sentence in the preamble is confusing. It appears that Treasury and the IRS may have intended to refer to \textquotedblleft chapter 1,\textquotedblright which would capture both §1 (imposing tax on trusts and individuals) and §11 (imposing tax on corporations). Until further guidance on the question is issued, AEIs will have to determine the extent to which they feel comfortable disregarding the NII of related taxable organizations.

Exceptions to the Related Organization Rule

Section 4968 contains two notable exceptions to the rule that AEIs take into account the NII of related organizations.

First, §4968 provides that no amount of NII will be taken into account with respect to more than one AEI.\footnote{§4968(d)(1)(A).} Accordingly, if an organization is a related organization to more than one AEI, its NII should be allocated between the AEIs. With respect to how the allocation should be made, the proposed regulations say only that \textquotedblleft [s]uch allocation must be made in a reasonable manner, taking into account all facts and circumstances, and must be used consistently across all related organizations.\textquotedblright

Second, §4968 provides that, with respect to organizations that are related to an AEI by virtue of controlling the AEI or being controlled by one or more persons that control the AEI (i.e., a \textquotedblleft brother/sister\textquotedblright relationship),\footnote{Prop. Reg. §53.4968-1(c)(2)(ii)(A).} the NII of the related organization is only taken into account by the AEI if it is \textquotedblleft intended or available for the use and benefit of\textquotedblright the AEI. This \textquotedblleft use or benefit\textquotedblright exception is not available, however, for organizations that are \textquotedblleft controlled by\textquotedblright AEIs. Curiously, the proposed regulations define \textquotedblleft control\textquotedblright in a manner that could be interpreted as rendering all \textquotedblleft brother/sister\textquotedblright corporations of an AEI as \textquotedblleft controlled by\textquotedblright the AEI and therefore ineligible for the \textquotedblleft use or benefit\textquotedblright exception. In particular, the proposed regulations instruct AEIs to apply the principles of §318 in determining the ownership of any entity, and those principles — specifically §318(a)(3)(C) — suggest that an AEI controls an entity with which it has a brother-sister relationship.\footnote{Prop. Reg. §53.4968-1(c)(1)(iii). The proposed regulations provide that an AEI controls a nonstock corporation if more than 50\% 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 AEI (with \textquotedblleft representative\textquotedblright meaning a trustee, director, agent, or employee, and \textquotedblleft control\textquotedblright including the power to remove a trustee or director and designate a new trustee or director). See Prop. Reg. §53.4968-1(c)(1)(ii)(D). The authors are grateful to Justin Lowe of Ernst & Young LLP for making them aware of this issue.} This appears to be an inadvertent \textquotedblleft glitch\textquotedblright resulting from the drafters’ borrowing their definition of control from §512(b)(13) and will hopefully be fixed in final guidance.

The \textquotedblleft use or benefit\textquotedblright exception is also not available to supporting organizations of an AEI. Although the statute does not expressly provide a transition or grandfather rule, the proposed regulations provide that supporting organizations that were \textquotedblleft Type III\textquotedblright supporting organizations (Type III SOs) to the AEI as of December 31, 2017, also qualify for the \textquotedblleft use or benefit\textquotedblright exception.\footnote{Prop. Reg. §53.4968-1(c)(3)(ii).} Accordingly, with respect to such Type III SOs, the proposed regulations provide that only the NII intended or available for the use and benefit of, or otherwise fairly attributable to, the AEI are taken into account. An AEI may determine whether the NII of such a Type III SO is intended or available for the use and benefit of, or otherwise fairly attributable to, the AEI using \textquotedblleft any reasonable method.\textquotedblright The proposed regulations note that treating all the distributions received from the Type III SO as NII of the AEI each year will be deemed a reasonable method.

CONCLUSION

The §4968 proposed regulations are the first proposed regulations to be issued under the new Code provisions enacted as part of the TCJA that are specifically applicable to tax-exempt organizations.\footnote{The other Code provisions specifically applicable to tax-exempt organizations are §4960, §512(a)(6), and §512(a)(7).} Although providing some welcome guidance, these regulations leave many of the most difficult questions presented by §4968 unanswered. With respect to NII, they do little beyond citing to the regulations under §4940 with minor modifications, which taxpayers reasonably would have looked to anyway.\footnote{Notably, the 2018 Form 4720 instructions have instructed AEIs to determine NII using §4940(c) and the regulations thereunder since Nov. 28, 2018.} Worse, in doing so, the proposed regulations make little effort to take into account the significant differences between the operations of a university and a typical private foundation and changes over the past 50 years in how tax-exempt organizations invest their assets, nor do they reflect any serious consideration of how an AEI...
should apply the basis step-up rule in the case of a partnership investment. Hopefully, affected universities will provide Treasury and the IRS with the comments they need to make substantial improvements in the final regulations that would, at a minimum, exclude GII and capital gains from exempt-use assets and provide AEIs with a practical approach for determining how to exclude pre-December 31, 2017 appreciation in partnership assets from capital gain net income.