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3 Significant Changes In The Final Endowment Tax Rules

By **Amy Lee Rosen**

Law360 (November 2, 2020, 6:57 PM EST) -- The Internal Revenue Service made some key changes in final regulations on the excise tax on private universities, concerning the definition of qualifying students, the treatment of pre-appreciation of donated assets, and which related parties are swept into the calculation.

In September the government finalized rules under Section 4968 of the Internal Revenue Code, which was included in 2017's Tax Cuts and Jobs Act and imposes a 1.4% excise tax on the net investment income of some private colleges and universities.

Here Law360 explores three important provisions in the endowment tax regulations.

'Tuition-Paying Student'

The excise tax is imposed on colleges and universities that have over 500 tuition-paying students, more than 50% of whom are located in the U.S., and hold assets other than those used in carrying out the institution's exempt purpose of at least $500,000 per student. However, the statute was unclear on what "student" actually meant, according to Liz Clark, the vice president for policy and research at the National Association of College and University Business Officers.

The proposed regulations defined student to mean someone "enrolled in a degree, certification or other program … leading to a recognized educational credential at an eligible educational institution" and can also include those enrolled in a study abroad program approved for credit.

Colleges and universities feared that this very specific definition of student would capture many who are not considered traditional students, inflating their numbers and subjecting more schools to the excise tax, Clark said. For example, in one instance a high school was located on a university's campus and the university did not know under the proposed rules whether students from the high school should be included toward the total count, she said.

Fortunately, in the final rules, the IRS changed course and determined it would be more appropriate and administrable to instead require students to be taking courses for academic credit to fall under the definition, Clark said. This definition of student in the final regulations makes it much easier for colleges and universities to tabulate who is enrolled and receiving credit, Clark said.

"The way that the final rules were written provides much more clarity in determining the student

count," she said.

Steven Bloom, director of government relations at the American Council on Education, said the final regulations were also clearer on what "tuition-paying" meant, which is very useful for colleges and universities in calculating the tax.

The proposed regulations defined "tuition-paying" to mean 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. While under the proposed rules funds provided directly by the university through scholarships or work study programs were not considered tuition, the rules also said scholarship payments provided by third parties, even if administered by the institution, would be considered tuition payments made by the student.

That definition meant that even when schools handled government-sponsored financial aid such as the Pell Grant — in which the student is awarded the money in a way similar to a voucher and the student assigns it and pays it to the school — the student would be considered a tuition-paying student under the proposed rules, Bloom said. For example, students at Berea College in Kentucky would be considered tuition-paying students under the proposed rules, even though they hand over no tuition to the college, since they pay for their schooling by working up to 20 hours a week, he said.

The final regulations kept the definition of "tuition-paying" in the proposed rules but added 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. What that means is that grants from governments, such as federal and state aid or something like the Pell Grant, will not count as tuition, Bloom said.

"Institutional aid, like a school giving its own money to support grants or scholarships to students that's the school's own money, will not count as a form of tuition payment," he said. "This is a good thing."

Pre-Donation Appreciation

Carolyn O. "Morey" Ward, a tax partner at Ropes & Gray LLP, said one area where the application of the private foundation rules was problematic related to how the proposed rules treated figuring out gain or loss on a property that a donor gives to an institution.

The excise tax statute says net investment income shall be determined under rules similar to Section 4940(c) of the IRC covering private foundations. Following Section 4940, the proposed rules said that an institution should compute gain on the sale of donated property using the donor's basis. So for example, if a donor made a gift of publicly traded stock worth $1,000 with a basis of $100, under the proposed regulations the $900 appreciation on that gift would have been included in the school's net investment income and become subject to tax, Ward said.

In response to public feedback, the final rules said any appreciation in the value of donated property that happened before the property was donated would be disregarded. This means when net investment income is calculated, the appreciation between the donor's basis and the fair market value at the time of donation isn't included in net investment income, Ward said.

Before the final rules came out, there was concern the proposed rules would discourage donors from contributing highly appreciated assets, because the appreciation would have been included in

determining the excise tax, she said. Going forward, colleges and universities will have to track future appreciation of the asset, assuming they don't immediately sell it, she said. However, many schools immediately sell the donated asset upon receipt and then invest the proceeds in their endowment, she said.

Related-Party Provisions

The final rules retained some definitional terms for which related parties' assets are included when determining total net investment income, but made an important exclusion for a type of trust over which a university typically has no control.

According to the proposed rules, the net investment income subject to the 1.4% excise tax can also include income from a related organization. The proposed regulations defined a related organization as one that controls or is controlled by the educational institution, any organization that is controlled by one or more people or entities that also control the educational institution, or an entity that is a supported organization as defined under Section 509(f)(3) of the Internal Revenue Code.

The definition is important, because as organizations are captured as related parties under the rules, that can increase the number of assets drawn into calculating net investment income, which means a higher excise tax, according to Alexander Reid of Morgan Lewis & Bockius LLP.

Many public comments said the definition in the proposed rules could lead to inequitable results, because a related party could include certain trusts in which an educational institution had a beneficial interest of more than 50%. That may occur with a type of split-interest trust called a charitable remainder trust, which disburses income to beneficiaries for a certain amount of time and donates the remainder to a designated charity in exchange for a partial tax deduction.

Usually the charitable remainder trust has one interest that goes to a private party, such as an heir, and when that beneficiary dies the remainder goes to a charity, Reid said.

The final rules noted that many comments asked for split-interest trusts to be excluded from the definition of a related organization because the college or university usually cannot receive any benefit from a trust until the beneficiaries' interests are terminated, even when the school has more than a 50% interest in the present value of the trust.

The IRS and the Treasury Department decided to exclude charitable remainder trusts from the definition of related parties in the final rules, saying it seemed contrary to congressional intent to tax an education institution on income paid to a grantor or other noncharity during the grantor's lifetime.

"Huge amounts of money are held in these trusts, and so carving them out of a related organization is a big win for colleges and universities," Reid said.

--Editing by Robert Rudinger and Joyce Laskowski.