

Proposed Rules on Endowment Tax Criticized as Too Far-Reaching

by Fred Stokeld

Proposed guidance on what's commonly referred to as a college and university endowment tax would affect a lot more than schools' endowments, two critics of the proposal warn.

REG-106877-18, released by the IRS and Treasury June 28, takes an "expansive interpretation" of the income categories that may be subject to the section 4968 tax, according to Alexander L. Reid and Kensington A. Wolgamott of Morgan Lewis & Bockius LLP.

If that interpretation is adopted in temporary or final regulations, more private colleges and universities would likely find themselves "with a greater amount of their income being subject to the excise tax than many had expected," the attorneys wrote August 2 on their firm's website.

Section 4968, established by the Tax Cuts and Jobs Act, imposes a 1.4 percent excise tax on the net investment income of applicable educational institutions with more than 500 tuition-paying students and nonexempt assets of at least \$500,000 per student.

Tuition-Paying Students

Unfortunately, the proposed regs' definition of tuition-paying students includes persons who depend on third-party scholarships and governmental assistance, "even if they do not in fact pay tuition," the authors say.

That would increase the number of colleges and universities subject to the tax, Reid and Wolgamott write. Schools would also be less likely to avoid the tax by enrolling fewer than 500 tuition-paying students because few if any colleges and universities can provide free tuition without relying on third-party scholarships or government aid, they explain.

Net Investment Income

NII is also defined expansively in the proposed regs, which cross-reference the section 4940 NII excise tax rules for private foundations. The proposed regs would tax interest, dividends, rent, and royalties that a school earns from its

assets, including assets used to advance its educational mission.

Theoretically, that means rental income derived from dormitories or faculty housing could be taxed, even though it's earned while pursuing the school's exempt mission, Reid and Wolgamott say, adding that rent on real property is generally not subject to the unrelated business income tax.

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A school's intellectual property could also be taxed under the proposed regs, they write, adding that "taxing a college or university on its intellectual property strikes at the heart of the institution."

Speaking Up

The proposed regs' interpretation of section 4968 is not "set in stone," Reid and Wolgamott note.

They urge the higher-education community to submit comments to the IRS and Treasury "to advocate for reasonable exceptions to the private foundation rules for activities that colleges and universities commonly undertake for mission-related purposes rather than solely to generate investment income."

Comments are due October 1. ■