October 1, 2019

The Honorable Steven Mnuchin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Mnuchin:

We write together to provide comments on the Notice of Proposed Rulemaking concerning the implementation of the excise tax on net investment income of certain private colleges and universities (Internal Revenue Code section 4968), pursuant to the enactment of the Tax Cuts and Jobs Act (84 FR 31795).

We remain opposed to this damaging and unprecedented tax that will not only reduce resources available to colleges and universities to promote excellence in teaching and to sustain innovative research, but also to increase access for low and moderate-income families through financial aid.

Over the last several months, we have worked together with expert outside counsel to develop the attached detailed comments. The comments seek to ensure that the regulations adhere to the intent of Congress. We recommend clarification of the criteria determining which institutions are subject to the excise tax to prevent capturing institutions not contemplated by Congress to be subject to tax. Furthermore, the comments explain why regulations for the excise tax on net investment income of private foundations should not be applied wholesale to universities. By instructing the Treasury to develop regulations that are similar to — but not the same as — the rules that apply to private foundations, Congress recognized that there are significant differences between private foundations and universities; we recommend revisions to the rules to recognize those differences. Finally, we have serious concern that the draft rules could lead to universities paying taxes on income accrued before the date the tax was enacted, on the full value of certain new gifts received from donors, on revenue generated from core educational and research functions, and on income of other entities, including income earned by taxable entities, which is not attributable to or received by universities.

While not every issue is a priority for each of us, we strongly believe that these comments provide thoughtful, constructive feedback to the proposed rules in a way that will reduce unnecessary administrative burden and respond to the unique characteristics of colleges and universities.

We appreciate your attention to this matter and are happy to continue to engage with the Treasury Department and the IRS in any way helpful to your work. If you have any

questions regarding these comments, please contact Rick Grafmeyer at Capitol Tax Partners LLP at 202-289-8700.

Sincerely,

Amherst College
Berry College
Bowdoin College
Brown University
Bryn Mawr College
Caltech
Claremont McKenna College
Colby College
Columbia University in the City of New York
Dartmouth College
Denison University
Duke University
Emory University
Grinnell College
Hamilton College
Harvard University
Haverford College
Massachusetts Institute of Technology
Medical College of Wisconsin
Middlebury College
Northwestern University
Pomona College
Princeton University
Rice University
Smith College
Stanford University
Swarthmore College
The Juilliard School
Trinity University
University of Chicago
University of Notre Dame du Lac
University of Pennsylvania
University of Richmond
Vanderbilt University
Wabash College
Washington and Lee University
Washington University in St. Louis
Wellesley College
Williams College
Yale University

cc: Ms. Janine Cook
Deputy Associate Chief Counsel, Tax Exempt & Government Entities
Internal Revenue Service

Ms. Elinor Ramey
Attorney-Advisor, Office of Tax Policy
U.S. Department of the Treasury

Mr. Jeff Van Hove
Senior Advisor, Office of Tax Policy
U. S. Department of Treasury

Comments on Notice of Proposed Rulemaking Under Section 4968

We commend the Treasury Department and the Internal Revenue Service (IRS) for the time and attention that has gone into implementing section 4968.[1] The Notice of Proposed Rulemaking (NPRM) provides a significant amount of information about the operation of the statute and the interpretative issues that the Treasury Department and the IRS must address in final regulations. The NPRM has also been helpful in prompting further thought about the scope and implementation of section 4968.

We very much appreciate the opportunity to share our views on a number of issues raised by the NPRM and to offer for your consideration our recommendations on these points. We have structured these comments to follow the order of the NPRM, and therefore they do not reflect a prioritization. We thank you for your continued thoughtful consideration of these issues.

I. INSTITUTIONS SUBJECT TO TAX

a. Background

Section 4968(a) imposes a 1.4% tax on the net investment income of each "applicable educational institution" for each taxable year. Section 4968(b)(1) defines an applicable educational institution subject to tax under section 4968(a) as an eligible educational institution (as defined in section 25A(f)(2)) that is not a state college or university and which had at least 500 tuition-paying students during the preceding taxable year, more than 50 percent of the tuition-paying students of which are located in the United States, and the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets which are used directly in carrying out the institution's exempt purpose) is at least $500,000 per student of the institution.

Section 4968(b)(2) provides that 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 NPRM proposes to define the term "student" for these purposes to mean "a person enrolled in a degree, certification, or other program (including a program of study abroad approved for credit by the eligible institution at which such student is enrolled) leading to a recognized educational credential at an institution, and who is not enrolled in an elementary or secondary school." Recognizing the importance of the definition of "student" in determining whether an educational institution is subject to tax, the NPRM requests comments on whether further guidance is needed regarding the definition of "student," "enrolled," or "attending."

Furthermore, an educational institution is subject to tax under section 4968 only if the aggregate fair market value of its assets at the end of the preceding taxable year (other than those assets which are used directly in carrying out the institution's exempt purpose) is at least

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

$500,000 per student of the institution. Consistent with the rules under section 4942,[2] the NPRM provides for a reasonable cash balance covering administrative expenses and normal disbursements to be treated as directly related to the educational institution's exempt purpose and thus excluded from total assets for purposes of determining whether an educational institution's total assets are at least equal to $500,000 per student. Analogizing to the rules under section 4942, the NPRM provides for a safe harbor under which a cash balance equal to 1.5% of the fair market value of an institution's non-charitable use assets will be deemed reasonable. Acknowledging that section 4968 requires annual measurement of an educational institution's assets per student whereas section 4942 uses the concept of a reasonable cash balance for purposes of a monthly measurement, the NPRM requests comments on whether another percentage or measurement should be deemed to be a reasonable cash balance at the end of the taxable year.

The following comments address the definition of "student" and the 1.5% safe harbor for reasonable cash balances proposed in the NPRM.

b. Comments on the NPRM

(i) *The definition of "student" should more closely track the concept used for purposes of the Lifetime Learning Tax Credit.*

Section 4968(b)(2) provides that for purposes of determining whether an entity is an "applicable educational institution," "the number of students of an institution . . . shall be based on the daily average number of students attending such institution." Relying on definitions used in Code section 25A related to the American Opportunity Tax Credit (AOTC) and the Higher Education Act (HEA) of 1965, the NPRM, however, requires a student to be both "*enrolled and* attending" an educational institution. (emphasis added) Defining the term "student" to refer only to those individuals who are both enrolled and attending an institution is inherently a narrower definition that describes a smaller group of individuals than a definition that refers to individuals who are attending an institution.

We believe that strict reliance on the definitions used in section 25A for purposes of the AOTC and under the HEA is misplaced, as the objectives of the AOTC and the HEA are quite different from the objective of section 4968. The HEA defines the class of students who are eligible for federal grants and loans, and section 25A defines the class of students eligible for a tax credit. Logically, the federal government would want to use somewhat narrow definitions of these groups in order to limit their scope to some degree. There is no similar need to limit the group of individuals who qualify as students for purposes of section 4968.

Furthermore, the wording of the statutes is different. The HEA uses the term "enrolled" in the statute itself, but not the term "attending." The use in section 4968 of the word "attending," unmodified by "enrolled," suggests a broader definition of "student" was intended

[2] Section 4942 describes the minimum distribution requirement for private foundations. In calculating their distributable amount, private foundations are permitted to exclude the aggregate fair market value of assets used (or held for use) directly in carrying out exempt purposes.

than the definition in the HEA.[3] Section 4968 also does not adopt the narrow definition used for purposes of the AOTC that a student is a person carrying at least one-half of the normal full-time course load. Instead, section 4968 permits any course load that can be converted to a full-time student equivalent basis. This likewise suggests that a broader meaning of the term "student" was intended for purposes of section 4968 than for purposes of the AOTC.

The use in section 4968(b) of the sole word "attending" without reference to "enrollment" suggests that a broader definition more similar to the definition for the Lifetime Learning Tax Credit (LLTC) in section 25A(c) would be appropriate. The LLTC adopts a broader definition of student and does not rely on definitions used in the HEA. The LLTC focuses on individual course work that may or may not lead to a degree.[4] In addition, guidance for the LLTC makes clear that a student may claim the credit even if expenses are not reported on IRS Form 1098-T (used to report education expenses) because the student is taking a course for which no academic credit is awarded.[5]

If section 4968 had been intended to adopt a narrow definition of the term "student," it could have specifically referred to the AOTC, used terms from such section such as "enrolled and attending" or referred specifically to the HEA (as the NPRM now does). But the statute does not use such terms or references, and instead solely uses the term "attending." This suggests that a broader definition of the term "student" that more closely tracks the concept used for purposes of the LLTC than that used for purposes of the AOTC is warranted. The Joint Committee on Taxation "Bluebook", which is intended to provide a further explanation of the tax reform bill, offers no additional guidance other than the clear language in the statute.

It is also important to note that students who are attending an institution but are not enrolled in a program leading to a recognized educational credential – that is, many community members, employees, distance learners, and executive education students – generally take a limited course load, typically on a less-than-half-time basis. In fact, at many institutions, it is believed that a significant percentage of the less-than-half-time students are *not* working toward a degree or other recognized educational credential. These students would not be considered eligible students for purposes of the HEA or the AOTC, which exclude students not taking at least a half-time course load, but would be eligible for the LLTC. However, section 4968 clearly indicates that less-than-half-time students *are* counted for purposes of the excise tax (on a full-time-equivalent basis). The fact that section 4968 deviates again from the HEA and AOTC approach by expressly capturing students taking classes on a very limited basis is consistent with

---

[3] A specific reference to "attending" or "attendance" in defining a student is also found in the Family Educational Rights and Privacy Act (FERPA). Under that statute, the term "student" generally means "any individual who is or has been in attendance at an educational agency or institution and regarding whom the agency or institution maintains education records." FERPA defines "attendance" to include "[a]ttendance in person or by paper correspondence, videoconference, satellite, Internet, or other electronic information and telecommunications technologies for students who are not physically present in the classroom." *See* 34 CFR § 99.3. If the Treasury Department and the IRS believe that an educational statute is the proper reference point for the definition of "student", FERPA would seem to be a more relevant reference point than the HEA given the use of the term "attending"/"attendance" in both section 4968 and FERPA.
[4] IRS publications clearly state that a "student does not need to be pursuing a degree or other recognized education credential."
[5] *See* Treas. Reg. § 1.25A-4(c).

the interpretation that even students who are not enrolled in a program leading to a degree or other recognized educational credential are intended to be counted. If the purpose of the assets-per-student test is to serve as a proxy for identifying the institutions that are the most financially equipped to pay a tax, then non-credential-seeking and credential-seeking students should be treated no differently, as an institution has to expend financial resources to educate all students, whether or not they are working toward a credential.

(ii) *The impact of the definition of "tuition-paying" on small schools should be considered.*

Another concern with the NPRM is that the test used to define students for purposes of the $500,000 threshold could have an adverse impact on certain small schools that may be on the cusp of having 500 tuition-paying students. Given the definition of a tuition-paying student in the NPRM, such schools may feel compelled to modify their tuition scholarship aid to provide fewer partial tuition scholarships and redirect such scholarships to entirely eliminate tuition for some students so as to fall below the threshold of having 500 tuition-paying students. Thought should be given to how tuition-paying students are counted for such small schools to avoid having an arbitrary threshold drive scholarship awards to certain students solely as a result of a desire to fall below the threshold.

(iii) *The 1.5% safe harbor used to measure an educational organization's reasonable cash balance treated as an exempt purpose asset should be deleted in favor of permitting an educational organization to make a determination of its reasonable cash needs.*

We believe there are key differences between educational organizations subject to section 4968 and private non-operating foundations subject to section 4942 that mandate a broader interpretation of the reasonable cash balance concept for purposes of section 4968 than for purposes of section 4942.

Private foundations are typically grant-making organizations that achieve their exempt purposes by making disbursements to other tax-exempt organizations. Colleges and universities, on the other hand, seek to achieve their charitable purposes not by making distributions to other charitable organizations, but by engaging in educational and research activities themselves. Recognizing the status of most private foundations as grant-making organizations, the regulations under section 4942 treat as exempt purpose assets the reasonable cash balance necessary to cover the foundation's current administrative expenses and other normal and current disbursements directly connected with the foundation's exempt activities.[6] The regulations therefore permit a grant-making private foundation to treat as exempt purpose assets certain amounts to be disbursed to grantees. The Treasury Department and the IRS should clarify that, similarly, section 4968 permits colleges and universities to treat as exempt purpose assets reasonable cash balances needed by an institution to cover expenses for its educational and research functions as well as to maintain cash reserves required for specific projects or bond covenants.

[6] Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(e); 53.4942(a)-2(c)(iv).

We propose that educational institutions be provided flexibility to determine their particular institution's reasonable cash balance for purposes of measuring assets used directly in carrying out the institution's exempt purpose. The 1.5% safe harbor from section 4942 should not be included in the final regulations as the relationship between a private foundation's need for operating cash and an educational institution's needs are dissimilar and the existence of a safe harbor could be read to suggest that a cash balance higher than 1.5% of non-charitable use assets may not be reasonable. Private foundations simply do not have the cash requirements for normal operating expenses that colleges and universities have in respect of their campus operations and payroll. Thus, the section 4942 safe harbor is not appropriate for purposes of section 4968. The final regulations should instead permit educational institutions to determine their own reasonable cash needs at the end of the taxable year. If challenged, educational institutions would be required to justify why the amount they excluded for purposes of determining their assets per student was an appropriate measure of their reasonable cash needs.

II. NET INVESTMENT INCOME AND BASIS OF PROPERTY

a. Background

Section 4968(c) provides that an applicable educational institution's net investment income subject to tax under section 4968(a) shall be determined under rules "similar to" the rules of section 4940(c). The NPRM incorporates the rules of section 4940(c) in defining and calculating net investment income, with a few very limited exceptions.

The NPRM requests general comments on the calculation of gross investment income, including 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, as well as specific comments on the treatment of rental income from housing and student loan interest. The following comments address (i) the mandate that the rules under section 4968 be "similar to" the rules under section 4940(c); (ii) the appropriate treatment of income derived from an educational institution's exempt functions, including particularly student loan interest, rental income from housing provided to students, faculty and staff, and royalties; (iii) the need for a rule permitting capital loss carryovers in determining net investment income under section 4968; (iv) the particular issues created by gifts of appreciated property; and (v) inside/outside basis issues in the context of investments in partnerships.

b. Comments on the NPRM

(i) *Section 4968's mandate that an applicable educational institution's net investment income shall be determined under rules "similar to" the rules of section 4940(c) does not require the rules under section 4968 to be "the same as" the rules of section 4940(c).*

The NPRM essentially takes the position that the statutory mandate that net investment income for purposes of section 4968 be determined under rules "similar to" the rules under section 4940(c) requires that the rules for purposes of section 4968 be "the same as" the rules under section 4940(c). We believe the statute does not require that the rules under section 4968 be the same as the rules under section 4940(c) and that the significant differences between private foundations subject to tax under section 4940 and educational institutions subject to tax under section 4968 require certain modifications to the rules under section 4940 in order to give effect to congressional intent to impose tax under section 4968 upon principles "similar to" those of section 4940.

As commonly understood, the word "same" implies that two things are identical whereas the words "similar to" does not. "Same" indicates that there is no difference, whereas "similar to" only indicates that there is some resemblance in appearance, character or quantity. Since section 4968(c) only requires the use of rules "similar to" the rules under section 4940(c), it is appropriate for the final regulations to evidence some flexibility in their application of the rules of section 4940(c) and not to attempt to rigidly apply the definitions of income and deductions found in section 4940 to section 4968. This interpretation is consistent with how the Treasury Department and the IRS have interpreted the term "similar to" in other contexts where two disparate sections of the Code use the term in reference to the rules applicable for purposes of such sections. When this has occurred, the regulations have adopted the commonsense definition of the term "similar to" and have not required the two subsections to have identical rules.

We believe certain modifications in how net investment income is determined for purposes of section 4968 relative to section 4940(c) are necessary to account for the significant differences between colleges and universities subject to tax under section 4968 and private foundations subject to tax under section 4940 and to give meaning to the words "similar to" as used in the statute. Unlike private foundations, which are typically grant-making organizations that achieve their exempt purposes by making disbursements to other tax-exempt organizations, colleges and universities seek to achieve their charitable purposes by engaging in educational and research activities themselves. Additionally, in contrast to private foundations (which typically receive gifts from a handful of closely related donors), colleges and universities subject to section 4968 receive a high volume of contributions from a wide range of donors. Given these differences, only with further modifications of the relevant rules, including those related to specific categories of income, capital loss carryovers, and gifts of appreciated property, will section 4968 achieve outcomes that are similar to those under section 4940(c).

(ii) *Certain categories of income derived from the direct performance of exempt functions should not be treated as net investment income of educational institutions.*

Whereas private foundations generally generate income to support their grant-making from contributions and investment activities, colleges and universities also generate income from their core educational and research functions. Certain categories of such income would technically fall within the scope of items of income treated as net investment income under section 4940 and, under the NPRM, by extension under section 4968. We believe, however, that treating such income derived directly from a college's or university's exempt function as net investment income is inconsistent with the intent of section 4968, which is aimed at taxing

generally passive-type income that, as the name suggests, is generated from investment activities. Income generated by an educational institution through the exercise of its core educational and research functions is, by definition, not generated through investment activities and therefore should not be treated as net investment income.[7]

Specific categories of income that would technically be included within the proposed definition of net investment income but should not be treated as such for purposes of section 4968 include student loan interest, rental income from certain student, faculty, and staff housing, and royalties derived from an educational institution's educational or research function.

1. Student Loan Interest

As the NPRM itself acknowledges, interest income from student loan programs is related to a university's mission and should be excluded from the definition of net investment income because loans under such programs are offered at rates and terms more favorable than similar commercial student loans. Such institutional loan programs are so integral to providing access to education for all students, regardless of income, that interest income from such programs is clearly distinguishable from interest income taxable under section 4940. We agree with the following observation in the NPRM:

> Loans are provided directly by an educational institution to its students to further its mission of educating its students. Unlike private foundations, colleges and universities educate students and charge tuition as part of their primary exempt activities. Student loans provided by an applicable educational institution to its students should be viewed as a form of deferred tuition which will be paid when the student enters the workforce. Thus, the interest on the student loan may arguably be distinguished from investment income, depending on the interest rate.

We surveyed many of the colleges and universities potentially subject to section 4968 to better understand schools' general practices in respect of student loans. The practices vary among institutions. Some institutions do not have substantial student loan programs; some view their loan programs as the avenue of last resort for students who cannot qualify for other programs; some focus their loan programs on certain types of students; and some have broad programs integrated into their overall financial assistance programs. Loan amounts also vary by school, with the highest loan amounts for most students in the $10,000 to $20,000 range and the lowest averaging approximately $3,000. The number of students covered by loans also varies by school – from a few dozen to a few thousand students. The one factor that is common amongst schools offering institutional student loans is that the terms of such loans, taken as a whole, are always more favorable than those of other commercially available student loans.

---

[7] We note in this regard that exempt operating foundations are not subject to tax under section 4940. Colleges' and universities' core educational and research activities, which form the basis of their tax exemption, are much more comparable to the direct charitable activities of exempt operating foundations that Congress intended to support and facilitate through enactment of the exempt operating foundation exception to section 4940 than they are to the passive grant-making activities of other private foundations that remain subject to excise tax under section 4940.

The types of loans and their features also vary among schools. Many institutional student loan programs benchmark their loan interest rate to a rate below the direct federal PLUS or Stafford loan program. However, focusing solely on interest rates compared to a federal loan program interest rate does not provide a complete picture. For example, the federal Stafford loan program may have an interest rate of 4.53%, but it also has a 1.062% origination fee, and a PLUS loan may have a rate of 7.6% with an origination fee of 4.248%. A similar university loan may have an interest rate of 5% but no origination fee. These university loan programs often have terms similar to or better than federal loan programs, as such loans are positioned to be available to students who may not qualify for federal programs.

In addition, most university loan programs have other features not offered by commercial lenders, such as delayed repayments and/or longer repayment periods, fixed rates, and fixed tuition and room and board rates based on the year the student enters the school. These features are all beneficial to students and distinguish loans provided by educational institutions from student loans provided by commercial lenders.

The NPRM raises concerns that an exception for student loan interest would create administrative difficulties. We believe these concerns are unfounded. There are clear differences between the terms of institutional loans and commercial loans. Most institutional loans are provided at fixed rates of interest, while commercial rates are generally provided at variable rates. The terms of institutional loans, taken as a whole, are more favorable than commercial loans. We therefore believe it would be appropriate to exclude all student loan interest from an educational institution's net investment income based on a presumption that such interest is earned in respect of loans provided on more favorable terms than those offered by commercial loan providers. If the IRS challenges this presumption based on the particular circumstances of an educational institution's student loan practices, the burden would be on the institution to distinguish its loan program from a commercial loan program and to demonstrate how its loans are provided on more favorable terms.

2. Rental Income from Student, Faculty, and Staff Housing

Housing provided to students is an integral part of the entire student experience, as it allows students to be surrounded by and interact with fellow students who are experiencing similar personal and educational growth. Similarly, faculty and staff housing is a critical strategic resource used by universities to recruit and retain exceptional personnel and to create a vibrant and dynamic residential and academic campus. Thus, rental income from student, faculty, and staff housing is integrally related to the educational mission and function of universities. The fact that student, faculty, and staff housing is critical to universities' academic priorities categorically distinguishes income from such housing from passive rental income of private foundations.

An informal survey of universities and colleges likely to be affected by section 4968 shows that undergraduate housing can be provided at rates 20% to 50% below that being charged by providers of commercial rental housing. In addition, undergraduate housing generally includes the presence of resident advisors who are available 24 hours a day to assist and oversee students. Similarly, graduate student housing is generally provided at below-market rates as compared to similar commercial rental units. Although graduate housing typically does not have

the oversight that undergraduate housing has, it still is intended to enrich the student experience by grouping together students with varied personal and educational experiences to further their personal and educational growth. Faculty and staff housing is varied, with some housing provided at below commercial rental housing rates and some provided at market rates.

Another reason to exclude rental income from housing provided to students, faculty and staff is to avoid the administrative burdens for both universities and the IRS that would be associated with tracking such income. Even for housing provided at market rental rates, the costs of providing such housing to the university will almost always exceed the income from such housing. Such housing is more frequently updated than commercial housing and it is provided usually with all utilities and Internet access included. In an informal survey of colleges and universities likely to be affected by section 4968, almost all stated that housing provided at below-market rates is a loss-generating activity. However, universities do not always account for each dorm or other housing facility on a building-by-building basis, as such income has not been considered taxable previously, and thus it has not been necessary to track costs incurred to maintain such units for tax purposes. Therefore, systems would need to be created solely to track costs from such housing activities that the universities are confident will generate a loss.

For the above reasons, the final regulations should make clear that all rental income from student housing, and rental income from faculty and staff housing provided at below-market rates, is excluded from the calculation of an educational institution's net investment income.

3. *Royalties*

In the course of teaching, research, and other intellectual and administrative activity by faculty, staff, fellows, students, and other individuals in the university community, discoveries or inventions occur, some of which may be patentable and offer the prospects of royalty income. Encouragement of such inventions is both supportive of the public interest and consistent with the advancement of knowledge, which is one of the primary purposes of teaching and research in a university. Universities conduct research not with an eye to the bottom line, but instead as part of their pursuit of knowledge for faculty and students. Royalty income can be a welcome result of successful research, but is not the university's goal. Thus, the generation of royalties from intellectual property is an integral part of the educational and research mission of universities. This distinguishes royalties earned by colleges and universities from royalties earned by private foundations, which generally are passive grant-making organizations and not involved actively in creating inventions. Accordingly, the final regulations should exclude royalty income derived from the educational or research functions of an applicable educational institution from the definition of net investment income. We acknowledge that royalty income earned by colleges and universities from passive investments unrelated to the exempt activities of the institution are more akin to royalty income earned by private foundations and therefore would not be included in this exception.

Royalties are a key component of income generated from research universities' mission-related activities and should be excluded from net investment income under section 4968 on that basis alone; however, it is also important to consider the administrative burden for universities involved in capturing all expenses and costs allocable to royalty income. For many universities,

royalties collected are first used to offset out-of-pocket expenses incurred by the university in applying for, obtaining, and defending a patent and in developing and negotiating license agreements during the life of the patent. Expenses for this purpose include fees paid to outside legal, consulting, and licensing organizations and any other out-of-pocket costs incurred by the university. The fees paid to the external individuals or organizations for such services may be fixed dollar amounts or may be in the form of an agreed-upon fraction of the gross royalty income, if any, or any other form directly associated with commercialization/licensing of the invention. Royalties are then split with inventors based upon many different types of formulas. Requiring universities to calculate their royalty income for purposes of determining their total net investment income may necessitate the creation of systems to capture historical and current costs related to the development of the discovery or invention to which the royalties received are related.

We also note that it makes little economic sense to require universities to capture and allocate research expenses and costs to royalty income collected, as for most universities, it is estimated that costs will exceed income by at least 75%-100%. The administrative and compliance burdens on universities and likely disputes with the IRS over costs and expenses allocated to such income thus are not only disproportionately significant, there is in fact little prospect of revenue being generated by including royalties derived from a university's educational or research function within the scope of net investment income subject to tax under section 4968.

4. Other Income from Programmatic Activities and Assets

The above-discussed categories represent specific categories of income generated by an educational institution in pursuit of its exempt purposes. More generally, however, we believe the final regulations should exclude from net investment income any income derived by an educational institution in the conduct of its core educational and research activities. As discussed above, unlike private foundations, colleges and universities engage in numerous direct activities to achieve their charitable missions and may earn income as a result of such activities. We believe income from such activities is categorically distinguishable from income earned by a private foundation through its investment activities and therefore should not be viewed as derived from "investment" even if it technically falls within the categories of income treated as investment income for purposes of section 4940.

We likewise believe the final regulations should exclude from net investment income any income and gain on the sale of property used by the educational institution in its programmatic activities. Such assets are excluded for purposes of determining whether an educational institution has assets in excess of $500,000 per student. There is an obvious disconnect between excluding such assets from the threshold calculations for determining applicability of section 4968 but still subjecting the income and gain from such assets to taxation under section 4968. If assets are excluded from calculations to determine applicability of the section 4968 tax, we believe income and gain from such assets should likewise be excluded from taxation once the institution has been determined to be subject to section 4968. Not only does this eliminate the disconnect between the per-student asset calculation and the income base subject to tax, it is also

consistent with taxing only an educational institution's investment income, not income derived from the educational institution's exempt function and purpose.

Given the mandate that section 4968 follow rules "similar to" the rules of section 4940, the rules under section 4968 should reflect the vast operational differences between colleges and universities, on the one hand, and private foundations, on the other. These operational differences support treating income earned by an educational institution from its core educational and research functions as other than investment income even if similar types of income are treated as investment income when derived by a private foundation from its investment activities.

(iii) *Section 4968 should allow for capital loss carryovers in calculating net investment income.*

The NPRM proposes to incorporate the rules of section 4940(c)(4) into the regulations under section 4968, which would have the effect of allowing losses from sales or other dispositions of property only to the extent of gains and prohibiting capital loss carryovers.

While this may be an appropriate rule for private foundations subject to tax under section 4940, we do not believe it is appropriate in the context of educational institutions subject to tax under section 4968. Private foundations have significantly more ability to time their sales of investment assets to match the recognition of gains with the recognition of losses. Unlike a private grant-making foundation, which, to the extent it has satisfied its minimum distribution requirements, can easily curtail its spending by issuing fewer or smaller grant awards to manage its section 4940 tax liability, an educational institution has a large operating budget with significant nondiscretionary expenses related to employees and infrastructure. An educational institution thus must find ways to meet its ongoing cash needs, which may involve selling investments at particular times that may not be advantageous from a tax perspective. Colleges and universities thus do not have the same control over their cash needs and may not be able to manage the timing of their gain and loss recognition in the same manner as private foundations. Given these differences between private foundations and educational institutions, we believe 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 federal income tax law first allowed for some type of net operating loss (NOL) carryover in 1918. Reasons offered to justify a carryover center around fairness and the annual reporting period. Congressional and court documents have described the carryover rules as equitable and fair, providing "essential protection[] against excessive hardships inherent in a tax based upon an arbitrary annual accounting,"[8] and "ameliorat[ing] the unduly drastic consequences of taxing income strictly on an annual basis."[9] In addition, an examination of all industrialized countries reveals that while rules regarding the carryback of capital losses may vary, capital loss carryforwards are universally permitted. This reflects a general understanding that capital loss carryovers are necessary to ensure that tax is imposed in a manner consistent

[8] S. Rep. 72-665 (1932)
[9] *Lisbon Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957).

with economic reality and is not imposed on artificially inflated income distorted by the concept of an annual accounting period.

Capital loss carryovers are more important today than ever given changes in the investment landscape. Investments in partnerships, which are becoming more and more prevalent, for example do not generally offer the same opportunity for timing gain and loss recognition that may be available with respect to more traditional investments to offset the adverse effects of the annual accounting period concept, as limited partners do not control the sales of assets within the partnerships. Thus, while it may have been justifiable to disallow capital loss carryovers when section 4940 was enacted in 1969, doing so today ignores the realities of modern investing.

Disallowing capital loss carryovers could significantly impact the effective tax rate for an educational institution subject to tax under section 4968 from one year to the next and would artificially inflate the actual net investment income subject to tax over the long term. For example, an institution that recognizes a capital loss of $3 million in year 1 and a capital gain of $10 million in year 2 would pay significantly more excise tax ($140,000) than if the same institution had instead recognized the total net capital gain of $7 million in year 2 ($98,000). Artificially high effective tax rates resulting from the inability to utilize capital losses in prior periods to offset gains in a later year are not balanced or economically sound. It is unlikely that members of Congress, when setting the 1.4% tax rate on net investment income, understood that strictly following the private foundation rules would result in potentially doubling the tax rate applicable to educational institutions during periods of stock market fluctuations.

The final regulations should therefore include guidance permitting capital loss carryovers in the calculation of the tax on net investment income.

(iv) *In calculating net investment income, educational institutions should be permitted to exclude appreciation in a gift of donated property that occurred prior to donation.*

The potential taxation of capital gains from the sale of donated property presents another particularly problematic issue under section 4968 and a concrete example of why the rules of section 4940 cannot simply be incorporated wholesale into the section 4968 context given the vast operational differences between colleges and universities, on the one hand, and passive grant-making private foundations on the other. Under section 4940, net investment income includes a foundation's "capital gain net income," which is generally equal to the excess of capital gains over capital losses realized with respect to any capital asset, subject to certain exclusions and modifications.[10] Such capital gain net income would generally include any gain realized on the sale of appreciated property received as a gift. The Treasury Department and the IRS have requested comments on whether a special rule excluding any appreciation in a gift of donated property that occurred before the receipt of such property by the applicable educational institution should be included in the final regulations and how such a special rule would be

[10] Section 4940(c)(4).

consistent with the statutory language of section 4968. We believe such a special rule is warranted for the reasons set forth below.

Private foundations subject to tax under section 4940 are generally passive grant-making organizations. Such foundations have the ability to dispose of appreciated property by making a grant of such appreciated property instead of selling such appreciated property and making a grant in cash. The regulations under section 4940 make clear that a foundation distributing appreciated property in the form of a grant that is a "qualifying distribution" (as most grants by private foundations are) does not realize any capital gain net income as a result of such distribution.[11] In other words, by making a grant of the appreciated property, the private foundation can avoid being subject to the section 4940 excise tax on any appreciation that occurred before the receipt by the foundation. The recipient of such a distribution would generally be a public charity, which could sell the property without being required to pay tax on the property's appreciation (as public charities are not subject to tax under section 4940 and the sale of the appreciated property likely would not give rise to unrelated business taxable income).

The rules under section 4940 thus enable passive grant-making private foundations to avoid taxation of gain on appreciated property by making grants of the appreciated property to other charitable organizations, which in turn can use the proceeds from the disposition of such property for their charitable activities without being subject to tax. Unlike passive grant-making private foundations, colleges and universities subject to section 4968 must fund substantial operations through which they engage directly in their charitable mission, i.e., teaching thousands of students through theory and practice, housing and feeding those students, and advancing knowledge for the betterment of society through scientific and other research. This entails enormous administrative and operational complexities, such as developing and maintaining housing, dining halls, museums, laboratories, patient care facilities, institutes, programs, and the like, which in turn requires substantial amounts of financial resources.

Unlike private foundations that can make grants of appreciated property received as gifts, colleges and universities nearly always liquidate the gifts and use the proceeds immediately to fund the institution's charitable activities or to provide longstanding if not perpetual support through the institution's endowment investments. Colleges and universities cannot avoid the recognition of net investment income (and resulting imposition of tax under section 4968) simply by making a grant of appreciated property in the manner private foundations can.

It is consistent with the statutory language of section 4968 for appreciation from the sale of gifts of property that occurred before the date of receipt to be excluded from the definition of net investment income. Section 4968 requires net investment income to be "determined under rules similar to the rules of section 4940(c)." As described above, the rules under section 4940 enable a private foundation to avoid taxation on the built-in gain in donated property by simply making a grant of such appreciated property to a public charity. Universities, as operating entities, are not in the position to make grants as private foundations can to avoid tax on such built-in gain. In order for the rules under section 4968 to operate in a manner "similar to" the rules under section 4940, the section 4968 regulations should provide a special rule that excludes

[11] Treas. Reg. § 53.4940-1(f)(1).

from the definition of "net investment income" appreciation from the sale of gifts of property that occurred before the date of receipt of such property by the applicable educational institution.

In addition to the exclusion of appreciation described above being consistent with the statutory language of section 4968, we note there is another important distinction between private foundations and colleges and universities that would support a different application of the excise tax to these two types of organizations. In contrast to private foundations (which typically receive gifts from a handful of closely related donors), colleges and universities subject to section 4968 receive a high volume of contributions from a wide range of donors. Obtaining cost basis information from these donors, which would be necessary if colleges and universities were required to calculate gain from the sale of gifts of property under section 4968 by including appreciation pre-dating their receipt of such property, would be extraordinarily burdensome.

We surveyed many of the colleges and universities potentially subject to section 4968 to better understand the number of non-cash donations they receive and the manner in which they receive tax information from donors. Non-cash annual donations ranged from 250 gifts at smaller schools to over 5,000 at larger schools. Even at the lower end of this range, the number far exceeds the number of property gifts received annually by the largest private foundations. It is not unusual for a large private foundation to receive only one or two non-cash gifts in a given year, and these gifts are often from donors who are well known to, and are likely in control of, the foundation. Colleges and universities are therefore in a very different position than private foundations with respect to contributions of property. As public charities with active fundraising operations, colleges and universities receive numerous property gifts annually from a wide group of donors. Many of these donors will not have access to cost basis information as some of the gifts relate to assets owned for decades, may not understand the request for cost basis information, or may not otherwise be forthcoming with the information. Indeed, some donors may be donating the property precisely because they do not know the cost basis and therefore do not wish to go through the process of calculating gain appropriately for tax purposes if they were to sell the asset. Colleges and universities are concerned that numerous requests to donors to obtain cost basis information could strain donor relations and adversely affect fundraising, ultimately leading donors to favor other charities that do not require donors to provide this information. Even if donors offer cost basis information, colleges and universities are concerned they may not be able to rely on the information without corroborating information. In sum, colleges and universities are concerned that being required to collect cost basis information from donors would entail an individualized back-and-forth process with donors that would consume an inordinate level of resources. The alternative to devoting such additional resources to information collection would be to assume a cost basis of zero for many property gifts, which could result in a significant overpayment of tax. In fact, institutions may very well end up needing to use a cost basis of zero even after devoting significant resources to the (unsuccessful) collection of donor basis information.

In addition to the arguments set forth above, we note that we do not view donations of property as giving rise to "investment income" in the first instance. Such property, which is nearly always liquidated immediately upon receipt, is not held for investment and any gain from the sale of such property should be excluded from net investment income on that basis alone.

(v) *Educational institutions should be permitted to use any reasonable method to reflect reportable gain following application of the partnership step-up rule*

IRS Notice 2018-55[12] and the NPRM provide that in the case of property held on December 31, 2017, and all times thereafter, the basis of such property for determining gain under section 4968 shall not be less than the fair market value of the property on such date (plus or minus any adjustments to basis after such date). This "step-up" rule is appropriate and consistent with rules promulgated under section 4940(c). The purpose of the rule is to exclude from the new section 4968 tax any built-in gain that accrued before the effective date of the tax.

Partnerships present particular issues under the step-up rule. Educational institutions are more likely to invest through partnerships now than they were approximately fifty years ago when the section 4940(c) rules were promulgated. The NPRM recognizes this development by allowing a partnership to apply the step-up rule to an educational institution's share of property held by a partnership on December 31, 2017, and all times thereafter. To avail itself of this special "partnership step-up" rule, the educational institution must obtain documentation from the partnership to substantiate the basis used. The NPRM does not describe what constitutes appropriate documentation. Depending on its scope and application, the documentation requirement would be challenging for educational institutions.

Educational institutions use partnerships in a variety of ways as a means for pooling investments. An educational institution may invest in (among others) hedge funds that hold a number of different assets, private equity funds that hold a more discrete number of assets, and funds of funds that involve chains of flow-through entities. Educational institutions generally are passive investors in these partnerships. The partnerships are managed by professional investment managers. The general partner makes all the investment decisions, and provides periodic reporting to the investors as required by the terms of partnership agreements or by law (e.g., Schedule K-1 to Form 1065). In many instances, the information provided to educational institution investors is on an aggregated basis. For example, Schedule K-1 reports the cumulative gain and loss on all capital assets sold during the taxable year. It does not separately report the results of each individual transaction.

In theory, the step-up rule applicable to partnership assets would be implemented and administered by the partnership itself. The partnership would step-up an educational institution's share of its basis in partnership assets to fair market value as of December 31, 2017, and report all subsequent activity on such stepped-up basis for pre-2018 assets. Unfortunately, we have no reason to believe that the managers of partnerships would implement these rules. Nothing in section 4968 or any other Internal Revenue Code provision requires partnerships to make or track these basis adjustments. Similarly, partnership agreements generally do not require such accounting. A partnership may have no way of knowing independently that a particular partner as of December 31, 2017 was an educational institution subject to section 4968, and whether the assets give rise to income subject to tax under section 4968. Even if a partnership had such information, it would have to keep two sets of books with respect to partnership assets in case the

[12] 2018-26 I.R.B. 773.

educational institution disposed of its partnership interest to a taxpayer that was not an educational institution subject to section 4968.

We do not believe partnership managers would be willing to bear the administrative burden required to implement the step-up rule at the partnership level. Thus, it will be up to educational institutions to apply the partnership step-up rule. In order to do so most accurately, an educational institution will need to know the fair market value and tax basis of each partnership asset for which it has a share as of December 31, 2017. It would then need to track each such asset until its disposition. An educational institution would need cooperation and information from the partnership managers to apply the partnership step-up rule on an asset-by-asset basis.

We do not believe an asset-by-asset determination by educational institutions is possible. First, an educational institution may invest in hundreds of partnerships. Each partnership will have numerous assets, which may be held through lower-tier partnerships. Tracking all these assets will represent an enormous administrative burden for educational institutions, even if they have all the relevant information. In addition, we do not believe educational institutions could receive all of the relevant information needed to apply the step-up rule on an asset-by-asset basis.[13]

We request that the Treasury Department and the IRS remove or clarify the documentation requirement and provide that educational institutions may use any reasonable method to reflect the amount of reportable gain following application of the partnership step-up rule. Educational institutions should not be precluded from using a step-up rule simply because they do not know (and cannot independently determine) the fair market value and tax basis of their allocable share of property held inside partnerships as of December 31, 2017 and cannot trace the disposition of these assets after such date.

We believe that educational institutions can develop reasonable methods that act as a proxy for applying the step-up rule to individual partnership assets. Educational institutions should know the fair market value of their partnership interests as of December 31, 2017. Educational institutions also should know, or have the ability to determine, the tax basis in their

---

[13] Managers of certain types of partnerships generally do not report the fair market values of the individual assets held by the partnership, but only report periodically on the overall fair market value of the partnership. Partnership agreements often do not require this asset-by-asset information to be provided. A manager of a fund of funds will not have the asset-by-asset information from the lower tier entities. A manager of a hedge fund may be concerned that asset-by-asset reporting will reveal confidential trading strategies. Partnerships that do not currently provide asset-by-asset valuations generally will be unable to reconstruct fair market values for individual assets retroactive to December 31, 2017 and, even if possible, will be reluctant to do so for only a subset of their investor partners (i.e., only educational institutions). Some funds provide transparency into the individual assets held. But even in these cases, the amount of information may be limited to only the largest partnership holdings (e.g., the top 10 positions or assets that exceed a certain percentage of the overall value of the fund). Even if some partnerships provide periodic valuations for specific partnership assets, no partnership reports the tax basis of individual assets to their investors on a regular basis. Thus, even if an educational institution knows the value of a partnership asset on December 31, 2017, it will not know the built-in gain attributable to such asset on that date. Further, the educational institution generally will not be able to track the disposition of a specific partnership asset after December 31, 2017, and will not know the amount received from the disposition of the asset.

partnership interests on December 31, 2017. Thus, they can calculate outside built-in gain as of December 31, 2017.

In most cases, educational institutions acquire their partnership interests by direct investment in the partnership. Thus, the educational institution's outside basis in its partnership interest should approximate its share of the inside basis of a partnership's assets (before the application of any step-up rule).[14] Similarly, the fair market value of an educational institution's partnership interest should approximate the fair market value of its share of a partnership's assets, regardless of how the partnership interest was acquired.

The difference between fair market value and tax basis of the partnership interests on December 31, 2017 should reflect the amount of cumulative built-in gain of the educational institution's share of the assets of the partnership on such date. This amount should not be subject to tax under the purposes of the step-up rule of the NPRM, and educational institutions should be allowed to use any reasonable method to attribute the known outside built-in gain to the unknown (and unknowable) inside built-in gain.

Educational institutions should be allowed to offset any inside gain recognized by the partnership and reported on Schedule K-1 after December 31, 2017 by the amount of this outside built-in gain determined as of December 31, 2017. The simplest and most administrable rule would allow an educational institution to determine its outside built-in gain as of December 31, 2017, and then not report as subject to section 4968 any capital gains[15] flowing through from the partnership after such date until the cumulative amount of such excluded gains equals the original amount of outside built-in gain. This rule would be applied on a partnership-by-partnership basis.

Admittedly, the proposed rule provides a timing benefit to educational institutions in that it allows the outside built-in gain amount to offset the first gains recognized and reported after December 31, 2017. The rationale for the front-end application of the rule is that (1) gains recognized and reported on Schedule K-1 soon after December 31, 2017, are more likely to represent the realization of December 31, 2017 built-in gain than are subsequent gains, and (2) the rule is relatively simple to administer. Applied this way, the rule could exclude any post-2017 appreciation to the extent the entire outside built-in gain amount has not been previously recovered. However, this generally will be only a timing difference as subsequently recognized gains that accrued before 2018 will become subject to tax. Nevertheless, if this timing is of

---

[14] Educational institutions may invest in pooled investment partnerships at their original formation or pursuant to a capital call to allow the partnership to make particular investments. In these cases, inside and outside basis should be the same. If an educational institution makes a contribution when an existing partnership has built-in gains, the reverse section 704(c) allocations will essentially conform inside and outside basis for purposes of recognizing future inside gain. Inside and outside basis will also be the same in those rare cases where the educational institution acquired its interest by purchase from another taxpayer at a gain and a section 754 election was made. If an election was not made, inside and outside basis may differ before the application of the step-up rules.

[15] For the first taxable year after December 31, 2017, the rule would apply to both long- and short-term capital gains. For subsequent taxable years, the rule would not apply to short-term capital gains flowing through from partnerships because such amounts could not have been included in the amount of outside built-in gain as of December 31, 2017.

concern, we would be happy to discuss with the Treasury Department and the IRS possible variations of the rule to address this concern.

III. RELATED ORGANIZATIONS

a. Background

Section 4968(d)(1) provides that assets and net investment income of any related organization with respect to an educational institution are treated as assets and net investment income, respectively, of the educational institution for purposes of determining whether an educational institution meets the asset threshold triggering application of section 4968 and determining the educational institution's net investment income subject to tax under section 4968. This related organization rule is subject to two exceptions: (1) assets and net investment income of a related organization are not to be taken into account with respect to more than one educational institution, and (2) unless the related organization is controlled by the educational institution or is a supporting organization of the educational institution for the taxable year, assets and net investment income which are not intended or available for the use or benefit of the educational institution are not to be taken into account.

Section 4968(d)(2) defines the term "related organization" to mean, with respect to an educational institution, any organization which (A) controls, or is controlled by, the educational institution, (B) is controlled by one or more persons which also control the educational institution, or (C) is a supported organization (as defined in section 509(f)(3)), or a supporting organization described in section 509(a)(3), during the taxable year with respect to the educational institution.

The NPRM proposes to define "control" for these purposes using the expansive definition of that term used under section 512(b)(13). The NPRM further confirms the general statutory rule that in the case of a related organization that is controlled by an educational institution or is a supporting organization described in section 509(a)(3) with respect to the educational institution, the assets and net investment income of such related organization are taken into account as assets and net investment income of the educational institution without regard to whether such assets and net investment are intended or available for the use or benefit of the educational institution (this rule is referred to herein as the "Full Inclusion Rule"). However, the NPRM provides a special exception to the Full Inclusion Rule for certain supporting organizations. Under this special rule, 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 and benefit of, or otherwise fairly attributable to, the educational institution.

Section 4968(c) provides that net investment income for purposes of section 4968 "shall be determined under rules similar to the rules of section 4940(c)." The NPRM elaborates on this mandate by providing that net investment income will be determined under the rules of section 4940(c) and § 53.4940-1(c) through (f), applying such rules by substituting "[a]pplicable educational institution" for "private foundation" and "foundation" each place they appear and by making certain other limited modifications.

b. Comments on the NPRM

We believe that certain aspects of the NPRM's interpretation of the rules requiring educational institutions to take into account assets and net investment income of related organizations under section 4968 create outcomes that are inequitable as a matter of tax policy and contrary to congressional intent. Rules are needed in the final regulations to avoid these illogical and unfair results that we believe Congress cannot possibly have intended.

The legislative history to section 4968 states as follows:

> In recent years, the endowment balances at many private colleges and universities have increased dramatically. At the same time, college tuition has risen at rates in excess of the rate of inflation. Where the endowment 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*.[16] (emphasis added)

We are concerned that certain aspects of the NPRM's interpretation of the rules requiring educational institutions to take into account assets and net investment income of related organizations are inconsistent with congressional intent to impose the excise tax on income "derived from the endowment," as income (and assets) well beyond an educational institution's own endowment could be swept into the calculation and thereby be subject to assessment of the excise tax.

Section 4968(c) provides that, for purposes of section 4968, net investment income will be determined under rules similar to the rules of section 4940(c), a clear indication of congressional intent that the excise taxes under sections 4968 and 4940 would operate similarly. However, section 4940(c) does not include a provision comparable to section 4968(d), regarding related organizations. This compels a careful tailoring of the rules applicable to related organizations to ensure educational institutions are not subject to a tax that differs in a material way from the tax imposed on private foundations under section 4940 (or, indeed, any tax imposed on virtually any other taxpayer) by subjecting an educational institution to tax in respect of income not derived from its endowment or to which it may never have any entitlement.

In the ordinary course of their operations, educational institutions routinely make arm's-length investments in entities that can fall within the scope of the related organization rules. Specifically, the investment portfolio of an applicable educational institution may include greater than 50% interests in investment vehicles in which other persons, which are unrelated to the applicable educational institution, hold the remaining equity interests. The holders of these remaining interests may be other investors or may be the investment manager, or an affiliate of the investment manager, of the vehicle. The investment vehicles are typically not organized by the educational institution; instead, the educational institution typically invests in these vehicles in arm's-length transactions. These vehicles are for-profit enterprises (i.e., not organized for

[16] H.R. Rep. No. 115-409, at 422 (2017).

charitable purposes). The holders of equity interests in such vehicles invest their own capital in, and, in the case of a manager, provide services to, the vehicle, and have contractual (or in the case of a vehicle that is organized as a corporation, statutory) entitlements to a return of their contributed capital and their shares of the vehicle's profits, as specified in the vehicle's governing agreement.

Even though an educational institution may have "control" over such an investment entity as that term is defined in section 512(b)(13)(D), the educational institution does not have any entitlement to the other equity holders' shares of the underlying net investment income or assets of the entity or any ability to divert the other equity holders' shares of the underlying net investment income or assets of the entity to itself or to a purpose chosen by the educational institution. Frequently, the educational institution will be a limited partner of, or will hold non-voting shares in, the investment vehicle. In that case, all decisions with respect to the investment vehicle are made by the vehicle's general partner or the holder(s) of the vehicle's voting shares. Even if an educational institution served as the general partner of, or held voting shares in, such a vehicle, it would be able to change the equity holders' entitlements to the vehicle's income only on a going-forward basis, if it could do so at all. It would not have the authority to override the other equity holders' entitlements to the vehicle's accrued income; any such override would constitute a breach of contract, fiduciary duty and/or applicable statutory provisions, as the case may be. To make changes on a prospective basis (e.g., through an amendment to a partnership agreement), the educational institution would in many cases need to obtain the consent of the other equity holders.

For the reasons described in further detail below, we recommend that the final regulations adopt the following recommendations to address the inequitable and, we believe, unintended consequences that would result from application of the rules described in the NPRM to educational institutions' investment activities.

(i) *An educational institution should be required to take into account assets of a related organization only to the extent such assets exceed the value of the interest in the related organization held by the educational institution that is already taken into account in determining the value of the educational institution's own assets.*

Without this simple rule, assets held by related organizations, interests in which an educational institution has already attached a value to in determining its own assets, would be double counted. An educational institution holding an interest in another entity that can be valued will be required to include the value of that interest in determining the fair market value of its own assets. This is the case regardless of whether the entity is a related organization of the educational institution. However, requiring an educational institution to treat the assets of a *related organization* as assets of the educational institution will result in double counting of the value of such assets to the extent such value is already reflected in the value of the interest held by the educational institution. Take, for example, the case of a wholly-owned corporate subsidiary of an educational institution that holds assets with a fair market value of $1 million. In determining the total value of its own assets, the educational institution will be required to take into account the value of the stock of that subsidiary, which would presumably be approximately $1 million. If the educational institution were required to also treat as its assets the assets of the

subsidiary, as the NPRM suggests, it would be required to take into account another $1 million in value attributable to such assets. Thus, investing $1 million in a wholly-owned subsidiary would cause an educational institution to double its assets with respect to such investment for purposes of determining the potential applicability of tax under section 4968. This is an illogical and inequitable result that Congress cannot possibly have intended.

The NPRM itself acknowledges this potential for double counting with respect to stock in a corporation that is a related organization, noting that "the institution likely already has included the value of the stock in its non-exempt use assets." However, this double counting problem is not limited to taxable corporations and applies with equal force in the case of partnerships and any other entities in which the educational institution holds interests to which it is able to ascribe a value for purposes of determining the total value of its own assets.

To avoid such double counting, an educational institution should be required to take into account assets of a related organization only to the extent such assets exceed the value of the interest in the related organization held by the educational institution that is already taken into account in determining the value of the educational institution's own assets for purposes of determining the potential applicability of tax under section 4968. This rule prevents double counting while addressing the concern stated in the NPRM that the value of a related organization's assets may at times differ from the value of an interest in the related organization itself.

(ii) *An educational institution should not be required to take into account the net investment income of a related organization that is a taxable corporation.*

Without further modification of the related organization rules, requiring an educational institution to take into account net investment income of related organizations that are taxable corporations will result in double taxation, and potentially triple taxation, of such income. Again, the NPRM acknowledges the issue, stating that "[s]ince the net investment that a taxable entity provides to an applicable educational institution has already been taxed under section 1 [sic],[17] the Treasury Department and the IRS do not consider it consistent with congressional intent to tax the income again under section 4968." The NPRM thus recognizes that treating net investment income of a taxable corporation as net investment income of a related educational institution has the potential to give rise to double taxation of such income. In fact, such treatment has the potential to give rise to *triple* taxation of the relevant income. Not only is income earned by a taxable corporation subject to taxation at the corporate level (the first level of tax), such income will be treated as net investment income when distributed to an educational institution as a dividend (the second level of tax). Furthermore, treating the net investment income of the taxable corporation as net investment income of the related educational institution would require the educational institution to pay tax under section 4968 on such income (the third level of tax).

This issue exists for both domestic and foreign corporations. First, the income of foreign corporations is in fact frequently subject to U.S. or foreign tax and the double taxation concerns discussed above therefore can apply in the case of foreign corporations as well. Second, the income of foreign corporations will be included in the net investment income of an educational

[17] We assume that this reference is intended to be to Code section 11.

institution holding an interest in the foreign corporation when such income is distributed to the educational institution as a dividend. And third, educational institutions that are related to foreign corporations for purposes of section 4968 will in many cases already be including the investment income of such foreign corporations in determining their own net investment income due to application of the "controlled foreign corporation" rules.[18] Separately computing the net investment income of the foreign corporation and treating it as additional net investment income of the related educational institution would therefore have the potential to result in double counting of such income and subjecting it to double taxation.

To give effect to the congressional intent of taxing net investment income only if such income is not otherwise subject to tax as expressly contemplated in the NPRM, an exception is needed excluding any such income from the net investment income an educational institution is required to take into account with respect to related organizations. Consequently, an educational institution should not be required to take into account the net investment income of a related organization that is a taxable corporation.

(iii) *The final regulations should clarify that an educational institution is required to take into account net investment income of a related partnership*[19] *in which the educational institution owns an interest only to the extent of the educational institution's allocable share of such net investment income.*

The NPRM could be read, as a technical matter, to require a partnership that is related to an educational institution to calculate its net investment income separately as an entity and to require an educational institution that owns a controlling interest in the partnership to treat as additional net investment income <u>all</u> of the net investment income of the partnership as so determined at the entity level. This treatment as the educational institution's net investment income would be in addition to the allocable share of partnership income and gains the educational institution includes in its income under general tax principles in determining its own net investment income. The final regulations should clarify that the rules of section 4968 are not intended to apply to partnerships in this manner.

Under general tax principles, a partnership is not subject to tax at the entity level. Instead, each partner takes into account its allocable share of the partnership's taxable income, as well as its allocable share of the items required to be separately stated under section 702. Consistent with these general principles, we believe a partnership should not be required, as an entity, to separately compute its net investment income. Rather, each educational institution that is a

---

[18] Under these rules, a U.S. person that is a greater than 10% shareholder (by vote or value) (a "U.S. Shareholder") in a "controlled foreign corporation" (any foreign corporation more than 50% by vote or value of which is owned by U.S. Shareholders) is required to currently include in its income its share of the "subpart F income" of the controlled foreign corporation. A foreign corporation's subpart F income includes most types of passive income included in the definition of net investment income. Given the 50% stock ownership threshold used for purposes of determining "control" of a stock corporation under section 4968, an educational institution that controls a foreign corporation within the meaning of section 4968 generally will be a U.S. Shareholder of the foreign corporation, the foreign corporation will be a controlled foreign corporation, and the educational institution will be required to include its share of the foreign corporation's subpart F income in determining its own net investment income.

[19] References to "partnerships" in this section are intended to cover all entities treated as partnerships for federal income tax purposes, including limited liability companies taxed as partnerships.

partner in a partnership should be required to take into account, in determining its net investment income, items of income, gain, loss, and deduction allocated to the partner by the partnership.

Such a rule is consistent with general principles treating partnerships as flow-through entities for tax purposes, including for purposes of imposing tax on net investment income under section 4940. Treas. Reg. § 53.4940-1(c)(1) (incorporated by reference into proposed Treas. Reg. § 53.4968-1(b)(2)) states that, "[e]xcept to the extent inconsistent with the provisions of this section, net investment income shall be determined under the principles of subtitle A." Subtitle A includes the general rules governing calculations of partnership items. There is no provision in these rules instructing partnerships on the calculation of their net investment income. Section 702 instructs partners, in calculating their income tax, to take into account their distributive share of partnership items required to be separately stated and their distributive share of the partnership's taxable income exclusive of the items required to be separately stated. Section 703 instructs partnerships to calculate their taxable income in the same manner as individuals, with certain specific exceptions. Without a similar rule regarding net investment income, it is not clear how a partnership that is a related organization for section 4968 purposes would calculate its net investment income. Requiring an educational institution to treat as its own all of the net investment income of a partnership that it controls would be a drastically different result than is currently the case for private foundations under section 4940(c), which are taxable only on their share of net investment income earned through partnerships. In fact, we are not aware of any Code provision having been interpreted to require a partnership to independently determine its own income for any purpose other than to determine allocations of such income to its partners.

A contrary rule would involve significant double counting. Under the rules for calculating net investment income, an educational institution that is a partner in a partnership takes into account items of income, gain, loss, and deduction allocated to the partner by the partnership. A rule requiring the partnership to separately calculate its net investment income and then treating all such partnership net investment income as net investment income of an educational institution that is both a partner in, and a related organization of, the partnership would double count the income and gain allocated by the partnership to the educational institution.

A contrary rule would also involve significant potential for double taxation. Any income earned by a partnership that is allocated to partners other than the educational institution that are taxable corporations, individuals, or trusts would be subject to tax in the hands of the other partners. As noted in the NPRM, where income is already subject to tax under section 1 (or, presumably, section 11), "the Treasury Department and the IRS do not consider it consistent with congressional intent to tax the income again under section 4968." A rule requiring a partnership to calculate its own net investment income and requiring an educational institution that is a related organization of the partnership to treat all of the partnership's net investment income as its own net investment income would create significant potential for income to be subject to tax under sections 1 and 11, as well as section 4968.

A rule requiring a partnership to separately calculate its net investment income would further be inconsistent with the policy reasons behind treating net investment income of related organizations as net investment income of an educational institution. The congressional intent

behind treating assets and net investment income of related organizations as assets and net investment income of an educational institution was apparently to capture the assets and net investment income available to the educational institution.[20] Treating items of income and gain allocable to other, completely unrelated, partners in a partnership, as investment income of an educational institution related to the partnership is not consistent with that intent. Take, for example, the case of an investment partnership in which an educational institution happens to hold a 51% interest in capital and profits and that earns $1 million in net investment income during a year. In a typical investment partnership, the entitlements of all partners in respect of partnership assets and income are fixed in advance and cannot be altered without the consent of partners that would be negatively affected by such change. In addition, under the rules governing allocations of partnership items of income, gain, deductions, and credits, such allocations are generally required to match the economic reality as to which partner is entitled to distributions with respect to, or required to bear the economic cost of, the relevant items. By definition items allocated to other partners thus cannot be expected to be available to the educational institution even if it holds more than 50% of the capital or profits interests in the partnership. Nevertheless, section 4968 could be interpreted to require the educational institution to take into account not only the $510,000 it is allocated by the partnership by virtue of its 51% interest in the partnership, but an additional $1 million in net investment income of the partnership as an entity, even though it will never have any rights to receive or benefit from that income. Even setting aside the issue of double counting and reducing the $1 million by the $510,000 the educational institution takes into account in determining its own net investment income as a result of allocations from the partnership, an interpretation that would require partnerships to separately calculate their net investment income would require the educational institution to take into account an additional $490,000 of net investment income it has no right to and can never reasonably expect to receive and which is wholly attributable to other partners.

(iv) *Certain categories of entities should be excluded from the definition of "related organization."*

Use of the definition of "control" under section 512(b)(13) for purposes of section 4968 without modification or further exceptions results in educational institutions being required to take into account assets and net investment income the use of which the educational institutions do not actually control, to which they have no entitlement, and which they will never receive. In fact, the NPRM would require educational institutions to treat, as their own, assets and net investment income that are used by, allocable to, and permanently set aside for the benefit of, unrelated third parties with whom the educational institutions interact only on an arm's-length basis. We believe such an outcome is inconsistent with congressional intent. Section 4968 provided for the Full Inclusion Rule in the case of related organizations that are controlled by an educational institution or supporting organizations of the educational institution, apparently presuming that where the educational institution has "control" over the related organization or is a supported organization of the related organization, the educational institution has sufficient power over the use and disposition of the assets and net investment income of the related organization to justify treating them as assets and net investment income of the educational

[20] The NPRM itself noted this intent (ironically when explaining the need for a 50%, rather than higher 80%, threshold for determining control), explaining that the threshold was chosen "to ensure consideration of *available assets* consistent with congressional intent." (emphasis added)

institution itself. In framing the statute in this manner, Congress clearly assumed that the educational institution would have the kind of control necessary to direct the use, and override any previously expressed intended use, of the related organization's assets and net investment income.[21] However, this is not the case if "control" for these purposes is defined in the broad manner of section 512(b)(13) without modification or further exceptions.

The definition of control for purposes of section 512(b)(13) relies heavily on economic ownership (in the case of stock corporations by measuring stock ownership by reference to vote or value, in the case of partnerships by measuring control by reference to interests in partnership capital or profits, and in the case of trusts by measuring control by reference to beneficial interests). It does not attempt to identify whether actual control is present. This is understandable, as effective control is not necessary to achieve the result section 512(b)(13) is intended to prevent. Under section 512(b)(13), a payment of interest, annuity, royalty, or rent that a tax-exempt organization receives or accrues from an entity it controls is treated as unrelated business taxable income (UBTI) to the extent that such payment is deductible by the controlled entity for U.S. federal income tax purposes. In this situation, without regard to whether the tax-exempt organization has effective control over the paying entity, (i) there is "double-dipping" in the tax system when a single payment both reduces the taxable income (or increases the net operating loss) of the paying entity and is tax exempt to the recipient and (ii) a tax-exempt organization receives an indirect economic benefit from a controlled entity's ability to deduct the payment. Importantly, section 512(b)(13) does not require a tax-exempt organization to include in the computation of its UBTI any payment the controlled entity makes to a person other than the tax-exempt organization, even though the controlled entity may be able to deduct that payment. Rather, it treats as UBTI only payments received or accrued by the tax-exempt organization itself.

Using economic ownership as a proxy for control may be appropriate in the context of section 512(b)(13) and we understand the Treasury Department's and the IRS's desire to define "control" for purposes of different sections applicable to tax-exempt organizations in the same manner. However, without additional special rules, use of the "control" standard of section 512(b)(13) does not produce appropriate results in the context of section 4968. Special rules are therefore needed to ensure the final regime remains consistent with congressional intent notwithstanding the expansive definition of "control" used in the NPRM.

There are a few categories of organizations that could be characterized as "related organizations" based on the definition of "control" provided by the NPRM but that should be excluded entirely from the definition of "related organization" on the basis that interpreting section 4968(d)(2) as including them as related organizations is unwarranted and inappropriate. These categories include certain trusts, retirement, health and welfare plans, and estates.

1. Trusts

---

[21] This intent can be inferred from the fact that the statute does not require an educational institution to take into account the assets and net investment income of any related organization which the educational institution does not control and which is not a supporting organization of the educational organization unless the assets and net investment are intended or available for the use and benefit of the educational institution.

The NPRM defines "control" of a trust as ownership of more than 50% of the beneficial interests in the trust. This definition is consistent with the definition of control of a trust provided by the instructions to Form 990, Schedule R and IRS Notice 2019-09.[22] The NPRM does not state how an educational institution's beneficial interests in a trust would be determined, but we assume based on similar wording in the instructions for Form 990, Schedule R, that a person's beneficial interest would be determined in proportion to that person's actuarial interest in the trust at the end of the tax year.[23]

A trust is created by a "settlor" (or grantor) who transfers assets to a trustee. The trustee must then hold and manage the assets for the benefit of the beneficiaries. The extent of a beneficiary's interest in a trust (a "beneficial interest") is determined by the language of the trust instrument, interpreted in light of all the circumstances.[24] The beneficiary of a trust has a property interest in the assets of the trust, which trust law deems to be equitable ownership rather than legal ownership,[25] but does not have any decision-making power in respect of the assets of the trust. Thus, under trust law principles, a holder of a beneficial interest – or even a majority of the beneficial interests – in a trust does not control the trust within the generally accepted meaning of that term.

A trustee of a trust similarly does not control a trust in a way that is relevant for purposes of section 4968. The trustee is required to administer the trust in accordance with, and the extent of the trustee's duties and powers are determined by, the terms of the trust, statutes, and case law.[26] A trustee is legally bound to manage the trust property in a responsible and productive manner, and is under an absolute obligation to act solely for the benefit of the trust's beneficiaries.

Given the limited roles of the trustee and the beneficiary, we believe it is appropriate for purposes of section 4968, for the definition of related organization (i) to exclude split-interest trusts described in section 4947(a)(2) and (ii) with respect to other types of trusts, be limited to those trusts with respect to which an 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 proposed exclusion to the definition of related organization would result in the appropriate characterization of certain trusts as related organizations. For example, a perpetual trust established by a donor of which an educational institution is both a beneficiary and a trustee and which provides the trustee(s) with the discretionary power to direct the trust's income and principal to the institution would be treated as a related organization for purposes of section 4968. Similarly, a trust established by an educational institution itself to which it transfers assets for its own benefit and with respect to which it has the ability as trustee to distribute income and

---

[22] 2019-4 IRB 403. Notice 2019-09 adopts the section 512(b)(13) control test for purposes of the definition of "related organization" under section 4960.
[23] 2018 Instructions for Schedule R (Form 990), p. 2.
[24] *See* Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, *Scott and Ascher on Trusts* §13.1. (5th and 6th Editions 2006-2019).
[25] *Id*.
[26] *Id*. at §16.1.

principal to itself would be a related organization of the educational institution for purposes of section 4968.

The first part of the proposed exclusion to the definition of related organization is intended to eliminate the unfair and illogical tax consequences that would result from the NPRM's proposal to define control in a manner that characterizes split-interest trusts as related organizations. For example, despite the fact that a beneficiary of a charitable remainder trust (CRT) does not control the CRT, the NPRM appears to treat a CRT in which an educational institution owns more than 50% of the beneficial interests as a related organization. Accordingly, the educational institution would be required to treat as its own all of the trust's assets and net investment income regardless of the fact that, as a remainder beneficiary, the trust's assets and investment income are not available to support the institution's mission until the termination of the interests of the income beneficiaries, which could be decades in the future. There is in fact no guarantee that the educational institution will ever receive anything from the CRT. For example, a donor could establish a CRT with appreciated securities and name an educational institution as the remainder beneficiary. If the CRT sells the appreciated securities in year 1 and the educational institution determines in year 1 that it owns, on a present value basis, more than 50% of the beneficial interests in the CRT, under the definition of related organization in the NPRM, it would be required to pay tax on the gain from the sale of the securities pursuant to section 4968. Depending on the payout to the CRT's income beneficiaries, the actual life span of the beneficiaries and the performance of the trust's assets, the remainder interest ultimately transferred to the educational institution may be far less valuable than the amount realized in year 1 and may even turn out to be worthless. Pursuant to the NPRM, once the institution's remainder interest falls in value such that it owns 50% or less of the beneficial interests, the CRT's assets and net investment income would no longer be treated as belonging to the educational institution for section 4968 purposes. However, the educational institution would have already paid tax on the CRT's net investment income earned in prior years, including the gain on the sale of securities in year 1. Under the NPRM, the educational institution would be required to pay tax on the CRT's net investment income in all years in which the CRT is a related organization, even if it does not receive the remainder interest for decades or never receives anything at all.

A rule requiring split-interest trusts to be treated as related organizations, contrary to the intent of the statute, would require such trusts to be treated *dissimilarly* to their treatment for purposes of section 4940(c). Pursuant to IRS Notice 2004-35, distributions from non-exempt charitable trusts described in section 4947(a)(1), split-interest trusts described in section 4947(a)(2), and estates are excluded from a private foundation's net investment income and thus are not included for purposes of calculating the section 4940 excise tax.[27] Assuming that a similar rule would apply to educational institutions for purposes of the section 4968 excise tax, distributions of income from a charitable lead trust to an educational institution would be excluded from the institution's net investment income and would not be subject to tax under section 4968. If, however, the same charitable lead trust is treated as a related organization for

[27] 2004-1 C.B. 889. In Notice 2004-35, the IRS announced its intention to propose regulations modifying Treas. Reg. § 53.4940-1(d)(2), which states that a distribution from a trust described in section 4947(a)(1) or (2) or from an estate does not retain its character in the hands of the distributee private foundation. Thus, these distributions are not included in net investment income for purposes of section 4940. Proposed regulations have not been issued but foundations are permitted to rely on the Notice.

purposes of section 4968, all of its net investment income must be included in the educational organization's net investment income. It seems nonsensical to treat a trust as a related organization and thus include its net investment income in the educational institution's net investment income when the trust's income would not be taxable if distributed to the educational institution.

In addition to the legal and fairness arguments explained above, it would be a significant administrative burden for an educational institution to identify all of the split-interest trusts of which it is a beneficiary, determine annually if it owns more than 50% of the beneficial interests in the trusts, obtain valuations of the assets held by the trusts, and calculate tax on the trusts' net investment income. While an educational institution will be aware of trusts for which it serves as trustee, an institution may also be the remainder beneficiary of hundreds of CRTs that have outside trustees. Donors frequently form CRTs without notifying the charitable remainder beneficiary. In these situations, the educational institution may not learn of the existence of the CRT until the death of the income beneficiary. These "unknown" trusts could be considered related organizations of educational institutions under the NPRM, but it would be impossible for institutions to take into account the assets and net investment income of such trusts. Even for trusts of which the educational institution is aware, there is no legal requirement that the trustees provide information regarding the trust's assets or income to a remainder beneficiary. It would be a significant burden for educational institutions – likely requiring hiring additional staff – to contact all of the trustees for asset and net investment income information, and it is unlikely that all of the information could be obtained at all, let alone be obtained with accuracy.

The second part of the proposed exclusion to the definition of related organization is intended to ensure that only trusts over which an educational institution exercises actual control are treated as related organizations. As explained above, using the section 512(b)(13) definition of control in this context would result in educational institutions being required to treat a variety of trusts over which institutions actually exercise no control as related organizations. It is only when an educational institution is both a beneficiary and a trustee with discretionary power to make current distributions to itself that it can be viewed as controlling the trust in such a way as to make the trust's assets and net investment income relevant for purposes of section 4968. The proposed definition correctly captures trusts with respect to which the educational institution has sufficient power over the use and disposition of the assets and net investment income to justify treating them as assets and net investment income of the educational institution.

2. *Employee Retirement, Welfare, and Deferred Compensation Plans*

Whether or not held in a separate trust, assets set aside or dedicated by an educational institution to fund or pay for retirement, health, and deferred compensation plans for employees of the institution and employee contributions to such plans should be explicitly excluded from the definition of "related organization" and the income from such assets should not be treated as investment income for purposes of calculating an institution's net investment income subject to tax under section 4968(a). The types of entities and assets covered by this exclusion should include (i) trusts formed to hold retirement, health or deferred compensation plan assets (e.g., defined benefit pension plans, defined contribution plans, VEBAs, and 457(b) assets held in a rabbi trust), and (ii) other assets set aside or dedicated by an educational institution to pay for the institution's commitment to provide certain employee benefits. The educational institution's use

of these assets and income therefrom is limited to the purposes for which the assets were set aside or dedicated and the educational institution therefore does not have a level of control over such assets and income that would justify treating such assets and income as assets and net investment income of the educational institution for purposes of section 4968.

3. Estates

Similarly, we request clarification in the final regulations that estates are not "related organizations" under section 4968. Estates are separate legal entities created at a person's death. It appears that estates would not be treated as related organizations based on the NPRM's definitions of "control"; however, it would be helpful if this point could be stated definitively in the final regulations.[28]

(v) *The special rule for Type III supporting organizations under Prop. Reg. § 53.4968-1(c)(ii)(2)(B)(3)(ii) should be extended to cover all such Type III supporting organizations, not only entities that were Type III supporting organizations of the relevant applicable educational institution on December 31, 2017.*

The Treasury Department and the IRS acknowledge that the statute, as interpreted in the NPRM, would create inequitable results in certain circumstances. To partially address these concerns, the NPRM creates a special rule for Type III supporting organizations in existence at the time section 4968 was enacted "[i]n recognition that section 509(a)(3) Type III supporting organizations, unlike section 509(a)(3) Type I and Type II supporting organizations, are not controlled by their supported organizations, and because applicable educational institutions may not be able to get information from their Type III supporting organizations." As the NPRM further recognizes, "[t]he relationship of a Type III supporting organization with its supported organization(s) is much more attenuated than that of the other two types" of supporting organizations. The NPRM thus recognizes that the type of control presumed by the statute to exist between educational institutions and related organizations that the educational institution "controls" or that are supporting organizations of the educational institution does not in fact exist in all circumstances and that a special rule was needed to address situations in which such control could not reasonably be expected to exist.

We commend the Treasury Department and the IRS for recognizing that the relationship between educational institutions and Type III supporting organizations warrants a special rule that requires educational institutions to take into account the assets and net investment income of such supporting organizations only to the extent such assets and income are intended or available for the use and benefit of, or otherwise fairly attributable to, the educational institution. That said, the stated rationale for this special rule for Type III supporting organizations applies without regard to whether such supporting organizations were in existence or Type III supporting organizations of the relevant applicable educational institution on December 31, 2017. There is

[28] Notice 2004-35, discussed above with respect to split-interest trusts, also provides that distributions from estates are excluded from a private foundation's calculation of its net investment income. We note that the argument described above with respect to trusts is equally applicable to estates: it seems nonsensical to treat an estate as a related organization and thus include its net investment income in the educational institution's net investment income when the estate's income would not be taxable if distributed to the educational institution.

no principled reason to treat Type III supporting organizations differently depending on when they came into existence or when their relationship with an applicable educational institution arose. As such, the special rule for Type III supporting organizations should be expanded to apply to all Type III supporting organizations.

(vi) *The final regulations should include a special rule for related organizations over which the educational institution lacks effective control similar to the special rule for Type III supporting organizations discussed above.*

In explaining the need for the special rule applicable to Type III supporting organizations, the NPRM cites specifically to the fact that Type III supporting organizations are not controlled by their supported organizations. This stated rationale for a special rule applies equally to other related organizations over which the educational institution lacks effective control and we recommend that the final regulations include a similar special rule for such other organizations.

Under the Full Inclusion Rule, as interpreted by the NPRM, an educational institution that owns more than 50% of the stock (by vote or value) of a stock corporation, more than 50% of the capital or profits interests in a partnership, or more than 50% of the beneficial interests in a trust, must treat as its own assets 100% of the corporation's, partnership's or trust's assets, regardless of whether such assets are intended or available for the use and benefit of, or otherwise fairly attributable to, the educational institution. This rule results in significant over-inclusion, even setting aside the issue of double counting the value of interests in the relevant entity and assets of the relevant entity as discussed above, when applied to entities over which the educational institution may have "control" within the meaning of section 4968 but which the educational institution cannot actually control, and we do not believe such application is consistent with congressional intent to tax only income derived from an educational institution's own endowment. As the NPRM itself noted (ironically when explaining the need for a 50%, rather than higher 80%, threshold for determining control), the threshold was chosen "to ensure consideration of *available assets* consistent with congressional intent." (emphasis added) Likewise, in discussing the net investment income of related organizations, the NPRM describes the relevant income as net investment income a related organization "provides" to the educational institution, suggesting again that the intent was to treat only net investment income that an educational institution can access as net investment income of the educational institution. Requiring an educational institution to treat as its own 100% of the assets and net investment income of a related organization over which the educational institution lacks effective control leads to consideration of assets and taxation of net investment income far in excess of those available or provided to the educational institution and is thus inconsistent with congressional intent.

We note that our recommendations set forth above regarding the net investment income earned by taxable corporations and partnerships address many of the concerns identified in respect of these entities' net investment income. Assuming these recommendations are adopted, the special rule set forth in this section would only prevent an educational institution from being required to treat as its own assets over which it has no effective control and to which it has no right or entitlement.

For the reasons set forth above, we believe it is appropriate to treat related organizations over which an educational institution lacks effective control in the same manner as Type III supporting organizations, over which the supported educational institution likewise lacks effective control. Under this proposed approach, the assets and net investment income of a related organization over which an educational institution lacks effective control would be treated as assets and net investment income, respectively, of the educational institution only to the extent such assets and net investment income are intended or available for the use and benefit of, or otherwise fairly attributable to, the educational institution. An educational institution would be able to use any reasonable method to determine the assets and net investment income of such related organization that are intended or available for the use and benefit of, or otherwise fairly attributable to, the educational institution. We would recommend that a method treating the portion of the assets and net investment income of the related organization that is equal to the educational institution's ownership percentage in the related organization be deemed reasonable.

We would further recommend defining "effective control" for these purposes in the same manner as such term is defined for purposes of section 4943(c)(2)(B), namely to mean "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of [the related organization], whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise."[29] As for purposes of section 4943(c)(2)(B), it would be "the reality of control which is decisive and not its form or the means by which it is exercisable." Section 4943(c)(2)(B), which applies for purposes of determining a private foundation's excess business holdings, provides a simple reference point that is appropriate for section 4968 as well given its focus on the realities of control.

To assist educational institutions faced with making numerous and complex determinations under the new regulations and to provide additional certainty, we further recommend that the special rule include a safe harbor under which an educational organization will be deemed to lack effective control over any limited partnership in which the educational institution (including through other related organizations) holds solely a limited partner interest. Under state law, limited partners generally have no power to manage or control the affairs of a partnership by virtue of their status as limited partners and partnership agreements generally provide limited partners only with very limited powers necessary for limited partners to protect the value of their investments. In fact, control by a limited partner over the business of a partnership is inconsistent with such partner's limited liability under state law.[30] As such, it is appropriate to treat an educational institution that is a limited partner in a partnership as lacking effective control over the partnership.

We believe the Treasury Department and the IRS have regulatory authority to define the scope of assets and net investment income of related organizations taken into account by educational institutions as outlined above and that the exercise of regulatory authority in such manner is consistent with congressional intent in enacting section 4968. The legislative history of

---

[29] Treas. Reg. § 53.4943-3(b)(3)(ii).

[30] *See, e.g.*, section 17-303 of the Delaware Limited Partnership Act (providing that a limited partner is not liable for the obligations of a limited partnership unless he or she is also a general partner or, "in addition to the exercise of the rights and powers of a limited partner, he or she also participates in the control of the business.").

section 4968 specifically provides that "[i]t is intended that the Secretary promulgate regulations to carry out the intent of the provision.[31]

Exercise of regulatory authority in the context of the related organization rules in particular is warranted by the fact that the rules under section 4940, to which the rules for determining net investment income under section 4968 are to be similar, do not take into account income or assets, or even include the concept, of related organizations.[32] Incorporation of the regulations under section 4940 into section 4968 without further changes therefore does not actually achieve Congress's intended result of imposing tax under section 4968 under principles "similar to" those set forth in section 4940. We believe considered exercise of the Treasury Department's and the IRS's regulatory authority is needed in order to address these problems and to ensure congressional intent of imposing tax on the net investment income of educational institutions under principles similar to those set forth in the rules under section 4940 is achieved.

* * *

We are grateful for the opportunity to share our recommendations with you and hope these suggestions are helpful as you continue to develop guidance implementing section 4968.

---

[31] H.R Rep. No. 115-466 (2017).

[32] Under the NPRM, as a technical matter, a related organization would not have any net investment income. As noted, the NPRM provides that net investment income will be determined under the rules of section 4940(c) and §53.4940-1(c) through (f), applying such rules by substituting "[a]pplicable educational institution" for "private foundation" and "foundation" each place they appear and by making certain other limited modifications. Section 4940(c) and §53.4940-1(c) through (f) instruct a private foundation on how to calculate its net investment income. Applying these rules with the above-described modifications, an applicable educational institution can determine its net investment income. However, there is no rule that instructs a related organization that is not itself an applicable educational institution on how to calculate its net investment income. While this appears to be a simple oversight that can be easily remedied in the final regulations, it illustrates the problems with attempting to incorporate the section 4940 rules wholesale into the section 4968 construct without modification to account for the fact that section 4968 requires an organization subject to tax under that section to take into account the assets and net investment income of related organizations whereas section 4940 does not.