



Tax Exempt & Government Entities

## **Tax Cuts and Jobs Act – EO Provision**

### **Excise Tax on Net Investment Income of Private Colleges and Universities IRC Section 4968 Provision 13701**

**Training based on TCJA guidance issued through  
September 30, 2018**

Slide 1

- Discuss enactment & amendment of IRC 4968
- Analyze “Applicable Educational Institution” definition
- Explain excise tax calculation on net investment income of private colleges and universities
- Review changes to Form 990 and Form 4720

## Slide 2

So we have a few objectives to get through with this presentation,

- One is to briefly discuss enactment and amendment of IRC 4968
- To analyze the definition of “Applicable Educational Institution”
- Define the calculation of the excise tax on the net investment income of private colleges and universities
- Finally, to review changes to Form 990 and Form 4720

- Excise Tax on Net Investment Income of Private Colleges and Universities
- IRC 4968:
  - Added by Sec. 13701 of the Tax Cuts and Jobs Act (P.L. 115-97)
  - Amended by Sec. 41109 of the Bipartisan Budget Act of 2018 (P.L. 115-123)

### Slide 3

So Section 13701 of the Tax Cuts and Jobs Act added Section 4968 to the Internal Revenue Code. Because of a procedural rule in the Senate, the legislation as initially proposed was amended shortly before passage. The amendment dropped the threshold provision relating to “tuition-paying students.” That provision was added back to Section 4968 by Section 41109 of the Bipartisan Budget Act of 2018. Now that is important because you want to be aware that the provision of the law, as it appears in the text of the Tax Cuts and Jobs Act, is not the current version. If you use Lexis or Westlaw to look at Code Section 4968, you will of course see only the amended version.



- Imposes a 1.4% excise tax on net investment income of an “applicable educational institution” (AEI)

#### Slide 4

The overall effect of section 4968 is to impose a 1.4% excise tax on the “net investment income” of an “applicable educational institution.”

That sentence encapsulates several technical points, which we will examine in the next few slides.

b) For purposes of this subchapter –

- 1) In general means an eligible educational institution (as defined in section 25A(f)(2)) --
  - (A) which had at least 500 tuition-paying students during the preceding tax year,
  - (B) more than 50 percent of the tuition-paying students of which are located in the United States,
  - (C) which is not described in the first sentence of section 511(a)(2)(B) (relating to State colleges and universities), and

## Slide 5

Spoiler alert: The general view is that the IRC 4968 excise tax will potentially apply to 40 or fewer schools. So, sorting out the definition of “Applicable Educational Institution” will seem a little like peeling a large metaphorical onion.

“Applicable educational institution” is defined in IRC 4968(b). This slide shows IRC 4968(b)(1) and its first three subsections ((A), (B) and (C)) as it appears in print.

Starting with the flush language [use star in white board to note this], IRC 4968(b)(1) borrows the term “eligible educational institution” from IRC 25A(f)(2).

IRC 25A is titled “American Opportunity and Lifetime Learning Credits.” IRC 25A provides for two different credits against the individual income tax. One of the threshold requirements for the credits is that the student must attend an “eligible educational institution.” This description-by-cross-reference is helpful, because it uses an established definition to identify the schools potentially subject to the tax under 4968.

As you might imagine, many educational institutions fall within this description. Subsections (A), (B), (C) and (D) under 4968(b)(1) narrow the population of schools subject to the tax.

I want to take the subsections out of order and look at 4968(b)(1)(C) first. That subsection uses a reference to the first sentence in IRC 511(a)(2)(B) to eliminate public colleges and universities from the definition of “applicable educational institution.” The first sentence of IRC 511(a)(2)(B) describes the following organizations:

“[A]ny college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions.”

Of course, this exception is alluded to in the title of the statute. However, the specific cross reference to the first sentence of 511(a)(2)(B) gives us a precise definition of the public colleges and universities that are not going to be subject to this excise tax.

Having looked at the broadest factors, let’s focus on the remaining threshold requirements under 4968(b)(1).

We start with the student counts.

The school must have at least 500 **tuition-paying students**. That’s in 4968(b)(1)(A)

More than 50% of those tuition-paying students must be located in the United States. That’s in 4968(b)(1)(B).

b) (1) (continued)

- (D) the aggregate fair market value of assets at the end of preceding taxable year (other than assets used directly in carrying out the institution's exempt purpose) is at least \$ 500,000 per student

Slide 6

The last point under 4968(b)(1) is subsection (D), which establishes a threshold based upon the “aggregate fair market value of assets” per student in 4968(b)(1)(D).

We’ll talk about the asset valuation issue in a moment. For now, we want to focus on the student counts.

- Daily average number of full-time equivalent (FTE) tuition-paying students
- IRC 4968(b)(1)(A) and (B) (student counts) refer to “tuition-paying students”
- IRC 4968(b)(1)(D) (ratio of assets per student) refers simply to “students”

## Slide 7

IRC 4968(b)(2) tells us that, for the purposes of 4968(b)(1), the school should base its counts on the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time equivalent basis.

Notice that 4968(b)(1)(A) and (b)(1)(B) use the term, “tuition-paying” student, whereas 4968(b)(1)(D) does not limit the term “students” in this way.



- Assets used directly in carrying out the organization's exempt purpose:
  - Apply principles of IRC 4942(e)(1)(A) and Treas. Reg. 53.4942(a)-2(c)(3)
- Fair market value:
  - Any reasonable method – consistently applied
  - Also, see Treas. Reg. 53.4942(a)-2(c)(4) for presumptively reasonable method

## Slide 8

Let's return now to the value of assets for the purposes of the calculation in IRC 4968(b)(1)(D).

We need to determine the fair market value (at the end of the preceding taxable year) of assets not used directly in carrying out the organization's exempt purpose.

Private foundations make a similar calculation when they determine their minimum distribution requirements under IRC 4942. Legislative history for section 4968, in House Report 115-466, at page 554, footnote 1252 describes "assets used directly in carrying out the institution's exempt purpose include classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets."

Our instructions to taxpayers tell them that they can apply the principles of section 4942(e) and Treas. Reg. 53.4942(a)-2(c)(3) to make this calculation. The regulations at 53.4942(a)-2(c) allow the organization to use any reasonable method, but require that they use the chosen method consistently. Treas. Reg. 53.4942(a)-2(c)(4) describes a presumptively reasonable method.

- Organizations that control/are controlled by the educational institution
- Organizations controlled by the same persons or persons who control the educational institution
- A supported organization (IRC 509(f)(3) or an IRC 509(a)(3) supporting organization) with respect to the educational institution that year

## Slide 9

We have another factor to consider as we determine whether we have an Applicable Educational Organization. We have to take into account assets held by “related organizations.” Related organizations include :

- Supported organizations that control or are controlled by the educational institution;
- Organizations controlled by one or more of the same persons who control the educational institution;
- Aion (IRC 509(f)(3) or an IRC 509(a)(3) supporting organization with respect to the educational institution during the tax year.

- Related organization assets & net investment income are not treated by educational institution:
  - To the extent treated as assets/income of another educational institution
  - If not intended for the use of the educational institution, unless:
    - Controlled by the educational institution, or
    - As supporting organization of the educational institution that year

## Slide10

Section 4968(d)(1) provides rules to avoid counting assets and net investment income of a related organization more than once.

- No amount (assets or net investment income) is taken into account with respect to more than one educational institution.
- Unless the related organization is controlled by the educational institution OR is a supported or supporting organization of the educational institution for the tax year, assets or net investment income “not intended or available for the use or benefit of the educational institution” are not included.



- Part V, Line 16. Private college and universities. Is organization an educational institution subject to 4968 excise tax on net investment income?
- If “Yes,” complete Form 4720, Schedule O

Worksheet: Threshold Tests for Section 4968

1. Daily average number of tuition-paying students dur the preceding taxable year
  - a. Daily average number of tuition-paying students without regard to location. \_\_\_\_\_
  - b. Percentage of tuition-paying students included on line 1a location in the United States. \_\_\_\_\_
2. Fair market value of assets not used directly in carrying out the organization's exempt purpose.
  - a. Held by the organization. \_\_\_\_\_
  - b. Held by one or more related organizations. \_\_\_\_\_
  - c. Total. Add lines 2a and 2b. \_\_\_\_\_
3. Divide line 2c by number of FTE students. \_\_\_\_\_

Slide 11

TEGE is working with Associate Chief Counsel on revisions to Form 990 and Form 4720.

Those of you familiar with Form 990 will know that we use Section V of the core Form 990 to identify compliance issues and other necessary forms the organization may need to file. We added a simple question to Form 990, which asks whether the filing organization is an organization subject to the section 4968 excise tax. If yes, we tell the organization to complete and file new Schedule O to Form 4720.

We’ve just spent several minutes walking through the definition of “applicable educational institution.” You can see that it isn’t necessarily a simple matter to know whether an educational institution is an Applicable Educational Institution for the purposes of section 4968. The instructions for Form 990, Part V, Line 16 include a worksheet to guide each private college or university through the process of determining whether it is an Applicable Educational Institution that must pay the excise tax.



## Net Investment Income - Generally

- In general, net investment income is determined under rules similar to the rules of IRC 4940(c):

$$\begin{aligned} \text{Net investment income} = & \\ & (\text{gross investment income} + \\ & \text{capital gain net income}) - \\ & \text{allowable deductions} \end{aligned}$$

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Excise Tax on Net Investment Income of Private Colleges and Universities

### Slide12

OK. So far, we've looked at the rules for determining whether the educational institution is an "Applicable Educational Institution" for the purposes of section 4968. If the answer is Yes, it needs to calculate its liability for the excise tax. So, let's shift our focus from whether we have an applicable educational institution to the excise tax the applicable educational institution must report and pay.

Section 4968(c) tells us to apply the principles applicable to private foundations under section 4940(c) in the calculation of net investment income under 4940.

The basic calculation has three elements:

- Gross investment income;
- Capital gain net income;
- Allowable deductions;

A comprehensive discussion of these elements is beyond the scope of this training. We will touch only on the surface issues.

- Includes:
  - Interest, dividends
  - Rents
  - Payments on securities loans (IRC 512(a)(5))
  - Royalties, and
  - Similar sources
- But exclude
  - UBTI
  - Tax-exempt income (IRC 103)

### Slide13

Gross investment income under IRC 4940(c) includes interest, dividends rents, payments with respect to securities loans (with a reference to the definition at section 512(a)(5)), royalties, **and similar sources**, with an exclusion for income subject to the unrelated business income tax under IRC 511. Also excluded is tax-exempt income from state and local bonds.

- Omit UBIT gains or loss
- Basis (Notice 2018-55 pending further guidance)
  - If gain – use FMV as of 12/31/17
  - If loss – normal basis rules of IRC 1011 through 1023 apply
- No capital loss carryovers or carrybacks

## Slide 14

Next, let's look at Capital Gain net Income.

We start with capital gains from all sources. Then, we omit capital gains that are subject to tax under section 511. We saw this also for gross investment income. We obviously don't want to tax the same revenues twice.

A transitional rule under 4940, allows private foundations to measure capital gains by reference to fair market value as of December 31, 1969. This transition rule prevented 4940 to have retroactive effect.

Associate Chief Counsel announced in Notice 2018-55 that we will be applying the same principle to section 4968. Thus the organization can measure capital gains from December 31, 2017. In the case of a gain, the basis is the greater of the basis or fair market value (with applicable adjustments, such as for depreciation and depletion). In the case of a loss, the normal basis rules in sections 1011 through 1023 apply.

Section 4968 does not allow any capital loss carryovers or carrybacks. Again, this is consistent with the principals under section 4940(c).



## Capital Gain Net Income - Losses

- General rule:
  - Capital losses allowed only to the extent of capital gains
  - No net capital loss offset against investment income
- Netting among related organizations:
  - Capital losses can be netted among related organization
  - Pending future guidance (Notice 2018-55, Sec. 4)

### Slide 15

Section 4968 raises an issue not present for private foundations. A private foundation reports only its own net investment income. As we have already discussed, an applicable educational institution needs to factor in amounts held by related organizations.

Associate Chief Counsel has announced in Notice 2018-55 that capital losses from the applicable educational institution or a related organization can offset capital gains. So, while the applicable educational institution cannot use an overall capital loss to offset gross investment income, capital losses among the related entities can offset capital gains to calculate an overall capital gain net income.





## Allowable Deductions - Generally

- Ordinary and necessary expenses paid/incurred for production or collection of gross investment income, or
- Management, conservation, or maintenance of property held for the production of such income

### Slide 16

The third factor in the calculation of net investment income is the allowable deductions.

In general, the expenses paid or incurred for the production, collection of gross investment income, or the management, conservation or maintenance of property held for production of that income are allowed as a deduction.

- Special rules for:
  - Depreciation (IRC 167) – straight-line only;
  - Depletion (IRC 611 and 613)
- Disallowed: expenses related to IRC 103 tax-exempt investments (IRC 265)

## Slide 17

In applying the deductions, rules under IRC 4940(c) limit depreciation to the straight-line method.

Special rules apply to the depletion deduction under IRC 611.

Also, we saw that income from tax-exempt investments (such as state and local bonds) is not included in gross investment income. Consistent with that approach, the general rule under IRC 265, applies to disallow expenses relating to those investments.



- Related organizations, exclude net investment income:
  - Taken into account with respect to another educational institution, and
  - From assets not intended or available for use or benefit of the educational institution unless the related organization is:
    - Controlled by the educational institution, or
    - A supporting organization of the educational institution

### Slide 18

Let's look again at related organizations.

We saw the information on this slide earlier in our discussion. There, we were determining whether we had an Applicable Educational Institution.

We are looking at these rules again because now we are locating the amounts our Applicable Educational Institution must include in (or should exclude from) the calculation of its net investment income.

IRC 4968(d)(1) tells us that we apply the same analysis for the purposes of 4968(b)(1)(D) (our definition of Applicable Educational Institution) and 4968(c) (calculation of net investment income). Note that 4968(d)(1) actually refers to (C) (the exclusion of public colleges and universities from the definition of Applicable Educational Institution – which doesn't make sense. We assume the cross reference will be fixed at some point in a technical corrections bill).

- Core Form 990, Part V, Line 16 trigger question
  - Is organization an educational institution subject to section 4968 excise tax on net investment income?
  - If “Yes,” complete Form 4720, Schedule O

## Slide 19

We’ve walked through the statute. Now, let’s take a look at how this change in the law will be reflected in our forms.

The excise tax on net investment income of private colleges and universities requires changes in two forms: The core 990 and Form 4720.

One consideration in the decision to modify a form because of a legislative change is the value of capturing the data that we need for our compliance function.

In doing that, we have to balance taxpayer burden against our need for data, as well as consideration of other available sources of comparable data.

With regard to 4968, the estimate is that the tax will actually apply to 40 or fewer schools and they already know who they are.

Data about eligible educational institutions described in IRC 25A(f)(2) already exists. We don’t need educational organizations to tell us that on Form 990.

The public colleges and universities don’t file Form 990.

That leaves information about student counts and asset values.

After considering the number of affected taxpayers, the budget issues involved in making major changes to a form, we settled on a single trigger question on Form 990 at Part V, new Line 16, supported by the worksheet in the instructions, which we saw earlier.



# Form 4720, New Schedule O

## Schedule O – Excise Tax on Net Investment Income of Private Colleges and Universities (Section 4968)

		(a) Name	(b) EIN	(c) Gross investment income (See instructions)	(d) Capital gain net income	(e) Administrative expenses allocable to income included in cols. (c) and (d)	(f) Net investment income (See instructions)
1	Filing Organization						
2	Related Organization						
3	Related Organization						
4	Related Organization						
5	Total from attachment, if necessary ...						
6	Total						
7	Excise Tax on Net Investment Income. Enter 1.4% of the amount in 6(f) here and on Part I, line 14.....						

### Slide 20

The big form change is in Form 4720, which is getting two new schedules. The 4968 excise tax is calculated on new Schedule O to Form 4720.

You will see on this draft that we prepared for Tax Forms & Pubs that we have full detail down the categories of income, gain and deduction, as well as across for the filing organization and each of its related organizations.

- Instructions for Form 4720, Schedule O
  - AEI reports for itself on line 1
  - AEI reports related organization amounts on lines 2-5
  - Related organizations report amounts for the year ending with or within the AEI's taxable year
  - Current instructions allow capital gains/losses netting
    - Subject to overall limitation that line 6, column (d) can't be less than zero
    - No capital loss carryovers or carrybacks allowed
  - Calculate the tax on line 7 (line 6(f) x 0.014)

## Slide 21

The filing organization reports its own information on line 1. We added lines 2-4 for individually named related organizations. Line 5 carries forward the totals for additional related organizations whose information won't fit on the 3 related-organization lines.

A related organization may use a different tax year than the filing organization. We tell the filing organization to report amounts for the related organizations for the related organization's tax year that ends with or within the tax year of the filing organization.

In the instructions, we tell the filing organization that column (d) (capital gain net income) for lines 1 – 5 can reflect capital losses. We tell the filing organization to total down the columns and enter the amounts on Line 6. The instructions provide that column 6(d) cannot be less than 0. We also tell the filing organization that it cannot take into account any capital loss carryovers or carrybacks.

The filing organization calculates the tax on Line 7 of Schedule O and then adds that tax to Part I of Form 4720, which captures all of the taxes that the filing organization might need to report and pay.

- Notice 2018-55
- Intent to issue guidance regarding calculation of net investment income for purposes of section 4968(c)
- Associate Chief Counsel soliciting comments

## Slide 22

It's difficult for us to predict anticipated guidance because guidance comes to us from Treasury and Associate Chief Counsel. We participate in, but do not control that process.

At this time, we have Notice 2018-55.

- Questions?

Slide 23

This is all I have for you on Section 4968.



- Discussed enactment & amendment of IRC 4968
- Defined “Applicable Educational Institution”
- Explained excise tax calculation on net investment income of private colleges & universities
- Reviewed changes to Form 990 and Form 4720

Slide 24

This is all I have for you on Section 4968.