

Locke Lord QuickStudy: Treasury and IRS Release Favorable Final Regulations on University Excise Tax

Locke Lord LLP

WRITTEN BY

Todd L. Cooper | Adam C. Harden

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On September 18, 2020, the United States Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “IRS”) issued [final regulations](#) (the “Final Regulations”) under section 4968 of the Internal Revenue Code of 1986, as amended (the “Code”), that address how to determine the excise tax owed by certain private colleges and universities. The Final Regulations are expected to become effective on the date of filing in the Federal Register.

Background

The Tax Cuts and Jobs Act (the “TCJA”), became law in December 2017 and created an excise tax on the Net Investment Income (the “NII”) of certain private colleges and universities. In June 2019, Treasury and the IRS issued proposed regulations (the “Proposed Regulations”) intended to provide guidance concerning this newly imposed excise tax. The Proposed Regulations generally addressed two critical issues – first, how to determine whether an educational institution qualifies as an Applicable Educational Institution (an “AEI”) that is subject to the tax, and, second, how to calculate the NII of the AEI. However, even after the release of the Proposed Regulations, certain questions remained unanswered, and, thus, the Treasury and the IRS requested comments and input from the public to better assist with the drafting and implementation of the Final Regulations.

Overview of Final Regulations

The Final Regulations seek to respond to such open items, particularly the treatment of interest income earned from student loans made by the AEI or a related organization, student housing rental income, royalty income derived from patents, copyrights, and other intellectual property and intangible property to the extent such assets come from the work of a student or faculty member, and clarification or modification of certain critical definitions, including “applicable educational institution,” “student,” “tuition-paying,” and “located in the United States.”

Interest Income from Student Loans

Although the Proposed Regulations noted the regulations under Code Section 4940(c) specifically include student loan interest as gross investment income, Treasury and the IRS requested comments on potentially distinguishing the interest earned based on whether the loan was made at a market rate or above market and

treating the interest in different manners. Nevertheless, after receiving numerous comments supporting the exclusion of all interest earned on student loans regardless of the terms, the Final Regulations have adopted the favorable position that all interest income from a student loan that was made by the AEI or a related organization to a student of the institution in connection with the student's attendance at the institution shall be excludable from gross investment income. Although Treasury and the IRS adopted this approach on student loans, they rejected the notion that faculty loans should receive similarly favorable treatment, so interest income on faculty loans must still be included in calculating NII.

University Housing Rental Income

In a surprising reversal from the Proposed Regulations and in response to a number of public comments, the Final Regulations exclude income received from the housing of current students of an educational institution from the gross investment income component of the NII calculation. Treasury and the IRS agreed that such income is distinguishable from other types of traditional rental income and should be excluded, regardless of whether the housing is provided to the educational institution's students by the institution or by a related organization of the institution.

Additionally, Treasury and the IRS further agreed with commenters that rental income from housing provided to an institution's faculty and staff should likewise be excluded from the NII calculation, especially if the rental agreement contains a provision that the person must be currently employed as faculty or staff of the AEI. However, the Final Regulations do not exclude rental income received from other persons, such as former faculty or former staff.

Royalty Income from Various Sources

The Final Regulations similarly draw a clear line between certain activities that produce royalty income. Specifically, the Final Regulations exclude royalty income derived from patents, copyrights, and other intellectual property and intangible property to the extent those assets come from the work of a student or faculty member in their capacities as such with the AEI. However, neither royalty income from trademarks on the institution's logo or name nor royalty income from intellectual property that is either donated or sold to the institution is excluded from gross income under the Final Regulations.

Clarification and Modification of Certain Definitions

The Final Regulations also clarified and modified certain definitions. Specifically, the Final Regulations adopted the definition of "applicable educational institution" as initially proposed.

Treasury and the IRS rejected a recommendation to substitute the definition of "student" in the Proposed Regulations with the definition contained in the Family Educational Rights and Privacy Act ("FERPA"). In doing so, Treasury and the IRS stated the FERPA definition is too broad and highlighted the definition included, for example, individuals who previously attended the institution. Instead, the Final Regulations define student to apply only to a person enrolled and attending a course for academic credit and charged tuition at a rate that is commensurate with the tuition rate charged to students enrolled for a degree.

The Final Regulations also adopted the definition of "tuition-paying" found in the Proposed Regulations, which

concluded that scholarships awarded by the institution are not tuition “paid” on behalf of the student, whereas scholarships from third parties are in essence payments of the student’s tuition, but the Final Regulations add that whether a student is tuition-paying is also determined after taking into account grants made by the Federal government or any state or local government.

The Proposed Regulations provided that the term “located in the United States” referred to the location of the student, and that the student is considered to have been located in the United States if the student resided in the United States for at least a portion of the time the student attended the institution during the AEI’s preceding taxable year, but Treasury and the IRS requested comments on whether further guidance was needed. One commenter requested flexibility for each institution to be permitted to determine whether a student is located in the United States using any reasonable and consistently applied approach. Treasury and the IRS responded that the Proposed Regulations contemplated that AEIs could make such a determination using any reasonable method, but the Final Regulations explicitly state this proposition.

Conclusion

While the Final Regulations may provide helpful clarification and favorable relief in certain areas, additional guidance and assistance will be required in analyzing and applying this tax. Our Public Finance and Tax attorneys continue to closely monitor and provide insight into the legislative and regulatory response to the Tax Cuts and Jobs Act. Should you require any guidance on these or any other matters, our team members stand ready to assist. Please contact the authors or one of your other Locke Lord attorneys with any questions.

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