

**How Big Is Too Big: Should Certain Higher Educational Endowments’ Net Investment Income Be Subject To Tax?**

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Section 13701 of the 2017 Tax Reform statute<sup>1</sup> created new Internal Revenue Code § 4968 that imposes a 1.4 percent excise tax on the net investment income of certain billion-dollar private college and university endowments.<sup>2</sup> The affected institutions must have:

(a) at least 500 tuition-paying<sup>3</sup> students during the preceding taxable year (provided more than fifty percent of its students are located in the United States),<sup>4</sup> and

(b) assets (other than assets used directly in carrying out the institution's exempt purpose) with an aggregate fair market value at the end of the preceding taxable year equal to at least \$500,000 per full-time or full-time equivalent student.<sup>5</sup>

To determine net investment income and whether the assets-per-student test is met, the income and assets of certain related organizations under the control or under common control of the institution generally are taken into account.<sup>6</sup> Public colleges and universities are not subject to this tax.<sup>7</sup> Approximately thirty to thirty-five institutions will be affected initially by the

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<sup>1</sup> P.L. 115-97, 131 Stat. 2054 (2017) (Codified as amended in scattered sections of 26 U.S.C.). In the House of Representatives, the bill was named the Tax Cuts and Jobs Act of 2017, but the Senate parliamentarian ruled that the title violated the "Byrd rule", which applies to bills moving under the "budget reconciliation" process that allows legislation to avoid a filibuster in the Senate. Under the rule, reconciliation bills can't include provisions that don't have an impact on the budget. The short title had no budgetary impact. See, Naomi Jagoda, *Senate parliamentarian rules against GOP tax bill's name*, The Hill, Dec. 19, 2017, available at: <http://thehill.com/policy/finance/365691-senate-parliamentarian-rules-against-gop-tax-bills-name>.

<sup>2</sup> Eligible educational institutions are schools offering higher education beyond high school and are eligible to participate in a program under title IV of the Higher Education act of 1965 that provides student financial aid by the U.S. Department of Education. I.R.C. §25A(f)(2). The full text of I.R.C. § 4968 is included in Appendix I.

<sup>3</sup> "Tuition paying" was added to the legislation in the February 2018 Bipartisan Budget Act, P.L.115-123, 132 Stat. 64 (Feb. 9, 2018) to exempt Berea College from the excise tax. See *infra*,

<sup>4</sup> The more than fifty percent of students located in the United States is designed to exclude institutions that have large numbers of foreign online students, who presumably would provide an exemption from the tax. These foreign students and others that may be studying in branches abroad are not included in the assets per student count, presumably because there is an assumption that they add little or no marginal cost to the educational institution.

<sup>5</sup> Exclusions from the Assets-per-FTE Calculation: The Joint Committee on Taxation summary explains that "assets used directly in carrying out the institution's exempt purpose" include, for example, 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, and are excluded from the assets-per-FTE calculation.

<sup>6</sup> Related organizations are controlled by the institution or is a supported organization described in I.R.C. § 509(f)(3), or a supporting organization described in I.R.C. § 509(a)(3) with respect to the applicable educational institution, A related organization's assets and net investment will not be treated as the assets and income of the educational institution if such assets and income are not intended or available for the educational institution's use or benefit unless the related organization is controlled by or is a supporting organization of the college or university.

<sup>7</sup> §4968(b)(1)(c) states that applicable educational institution excludes state colleges and universities by reference to I.R.C. §511(a)(2)(B). That section indirectly defines state colleges and universities as "any 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."

legislation.<sup>8</sup> As institutions' endowment assets grow, additional colleges and universities will become subject to the tax.<sup>9</sup> The new tax is effective for taxable years beginning after December 31, 2017.<sup>10</sup> As most educational foundations operate on a July 1 to June 30<sup>th</sup> fiscal year, the first year the investment income tax will apply will be fiscal 2019.<sup>11</sup> The excise tax on the net investment income of certain large endowments was enacted after several years of scrutiny and commentary on the enormous growth of college and university endowments and even larger annual tuition increases by those same institutions.

This article will review and critique the existing endowment excise tax legislation. It also will raise the controversial issue of whether all, or merely the largest endowments should be subject to any tax whatsoever and will recommend that the revenue from the tax be applied to educational programs.

The paper will offer an overview of Congressional and academic criticism of the largest endowments, discuss the changes in approach to endowment investing, the growth of educational endowments, and will suggest that endowments subject to the tax should be able to reduce or offset their excise taxes by engaging in certain public policy initiatives.

Throughout the paper, Harvard, Princeton and Yale are used as examples. They have been chosen for their success, not as criticism. Harvard has the largest endowment, Princeton

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<sup>8</sup> See, Andrew Kreighbaum, *Final GOP Deal Would Tax Large Endowments*, *Higher Education*, December 18, 2017 available at [https://www.insidehighered.com/news/2017/12/18/large-endowments-would-be-taxed-under-final-gop-tax-plan?utm\\_source=Inside+Higher+Ed&utm\\_campaign=39cce06ca0-DNU20171218&utm\\_medium=email&utm\\_term=0\\_1fbc04421-39cce06ca0-226888949&mc\\_cid=39cce06ca0&mc\\_eid=14d3c6afe2](https://www.insidehighered.com/news/2017/12/18/large-endowments-would-be-taxed-under-final-gop-tax-plan?utm_source=Inside+Higher+Ed&utm_campaign=39cce06ca0-DNU20171218&utm_medium=email&utm_term=0_1fbc04421-39cce06ca0-226888949&mc_cid=39cce06ca0&mc_eid=14d3c6afe2). The National Association of Independent Colleges and Universities estimates the tax will affect 35 colleges—0.8% of the nation's 4,583 colleges.) Ames Brown, *The GOP Tax Bill Will Benefit Colleges -- Even Those With Endowments It Now Taxes*, *Forbes*, April 3, 2018 available at <https://www.forbes.com/sites/amesbrown/2018/04/03/tax-reform-college-endowments/#47e4f2381bc3>.

<sup>9</sup> For projections of institutions to be affected depending upon endowment growth rates see, Rick Seltzer, *Estimating the Endowment Tax's Future: The number of institutions subject to the newly enacted tax could grow by dozens in future years*, *Higher Education*, January 4, 2018, available at <https://www.insidehighered.com/news/2018/01/04/dozens-more-colleges-will-pay-endowment-taxes-if-growth-rates-continue>.

<sup>10</sup> In a Notice and accompanying News Release, the IRS announced that it will issue proposed regulations with respect to the 1.4% excise tax on net investment income that applies to certain educational institutions for tax years that begin after Dec. 31, 2017. Among the rules in those proposed regulations is one providing that, for purposes of the 1.4% tax, an institution selling property at a gain generally may use the property's fair market value at the end of 2017 as its basis for figuring the tax on any resulting gain. Notice 2018-55, 2018-26 IRB; IR 2018-134, (June 8, 2018). This stepped up basis should reduce net investment income for assets held for many years that have appreciated over time.

<sup>11</sup> *Id.*

has the most endowment assets per student, and over time Yale has demonstrated the best investment prowess.

**Table 1**  
**Endowment Assets Per Student**

	Total Endowment / Number of Students	Endowment Assets Per Student (in millions)
Harvard	\$37.1 billion / 22,000	\$1,686.363
Princeton	\$23.8 billion / 7,979	\$2,982, 829
Yale	\$27.176 billion /12,458	\$2,181.409

## **I. A Primer on Endowments**

### *The Definition of an Endowment*

An endowment is a fund that provides a stream of income and maintains the corpus of the fund in perpetuity.<sup>12</sup> Organizations with large endowments, such as colleges, universities, and private foundations,<sup>13</sup> all finance a significant part of their operations through the returns received from the investment of this capital.

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<sup>12</sup> The legal definition of an endowment fund is an institutional fund or part thereof, not expendable by the institution on a current basis under the terms of the applicable gift investment. UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 2(2) (2006). However, the word “endowment” generally is used in a broader sense than just the permanent corpus of the fund. Quasi-endowment is a term that describes unrestricted capital gifts which the charitable institution has decided to treat as endowment. Endowment funds are contrasted to funds, such as tuition revenues, which typically are held for a very short term and are likely to be invested in treasury bills or commercial paper. Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University, Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules*, 28 REAL PROP. PROB. & TR. J. 49, 51 n.4 (1993).

<sup>13</sup> Private foundations are charities that have failed certain tests of public support under I.R.C. For the 2014 tax year,

Accounting classifications of endowments differ from legal definitions. Permanent or classic endowment funds are restricted in their purposes by donors to provide long term funding for designated purposes. Unrestricted net assets are not subject to donor-imposed restrictions. Temporarily restricted net assets consist of donor-restricted endowment funds that are not classified as permanently restricted net assets.<sup>14</sup> When donor restrictions expire—a stipulated time restriction ends or a purpose restriction is fulfilled—temporarily restricted net assets are reclassified to unrestricted net assets and reported as net assets released from restrictions.<sup>15</sup>

### *Net Investment Income*

I.R.C. § 4968 defines net investment income using the rules of I.R.C. § 4940(c), which deals with the excise tax on the net investment income of private foundations.<sup>16</sup> Net investment income is defined as gross investment income<sup>17</sup> plus capital gain income minus allowable deductions.<sup>18</sup>

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97,484 domestic private foundations reported \$715,147 billion in total assets. I.R.S. STAT. OF INCOME BULL., DIVISION PRIVATE FOUNDATION STUDY, October 2017, available at <https://www.irs.gov/statistics/soi-tax-stats-domestic-private-foundation-and-charitable-trust-statistics>. § 509 (2018). Private foundations typically are funded through a gift of assets that becomes an endowment, and grants are paid out of the earnings generated. I.R.C. § 4942(e)(1) requires private foundations to spend at least 5% of their current investment asset value for charitable purposes. I.R.C. § 4942(e)(1) (2017).

<sup>14</sup> Effective for fiscal years after December 15, 2017 and for interim periods within fiscal years beginning after December 15, 2018, the Financial Accounting Standards Board (FASB) will require Not-for-Profit Entities to change its classes of net assets from three to two: net assets with donor restrictions and net assets without donor restrictions, as well as the previously required amount for total net assets. FASB Accounting Standards Update, Not-for-Profit Entities (Topic 958) 2016-14 (Aug. 2016) available at [http://www.fasb.org/cs/ContentServer?c=Document\\_C&cid=1176168381847&d=&pagename=FASB%2FDocument\\_C%2FDocumentPage](http://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176168381847&d=&pagename=FASB%2FDocument_C%2FDocumentPage).

<sup>15</sup> See Financial Accounting Standards Board, Staff Position No. FAS 117-1. The restrictive spending policies of UPMIFA would apply only to true endowments with restrictions. UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 2(2). All types of endowment categories are commingled for investment purposes and are referred to as “endowment.” At Harvard in the fiscal year 2017, 64.7% of the endowment is classified for accounting purposes as temporarily restricted; 18.1% as permanently restricted; and 16.6% as unrestricted. HARVARD UNIVERSITY FINANCIAL REPORT FISCAL 2017 16 (2013), available at <http://vpf-web.harvard.edu/annualfinancial/pdfs/2013fullreport.pdf>. Yale’s figures in the fiscal year 2017 were 69.8% temporarily restricted; 15.2% permanently restricted; and 11% unrestricted. YALE FINANCIAL REPORT 2016-2017 15 (2017), available at [www.yale.edu/finance/controller/reporting/reports.html](http://www.yale.edu/finance/controller/reporting/reports.html).

<sup>16</sup> I.R.C. § 4940(c).

<sup>17</sup> Gross investment income is defined as income from interest, dividends, rents, payments with respect to securities loans (as defined in I.R.C. §512(a)(5) and royalties, but not including any such income to the extent included in computing the tax imposed by I.R.C. §511. Such term also includes income from sources similar to those in the preceding sentence. Treas. Reg. § 53.4940-1.

<sup>18</sup> Allowable deductions include ordinary and necessary expenses paid or incurred and tax exemptions paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications set forth in subparagraph (B). I.R.C. §4940(c)(3).

## *The Rationale of Endowments*<sup>19</sup>

Intergenerational equity is the most commonly stated goal for endowment management. As stated by the Nobel Prize winning economist, James Tobin: “The trustees of an endowment institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations.”<sup>20</sup> This means that tomorrow’s students, scientists, patients, beneficiaries, or parishioners will receive the same or greater benefits, accounting for inflation, as today’s beneficiaries. Another common rationale for endowments is that they enable organizations to smooth out revenue shortfalls and maintain the same scale of activities in lean years as in bountiful ones.<sup>21</sup> The financial crisis of 2008-09 called into question both rationales. Colleges and universities did not increase their spending rates to smooth out the endowment spending shortfalls, and budget cutbacks were so severe at many educational institutions that intergenerational equity for current students and other beneficiaries was not maintained.<sup>22</sup>

## *Approaches to Endowment Investing*

Initially, endowments were gifts of property given to institutions to provide them with a source of dependable income from rents or interest.<sup>23</sup> Growth was achieved primarily through additional gifts, and endowment funds were invested quite conservatively. English law encouraged

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<sup>19</sup> This section is derived and updated from: James J. Fishman, *What Went Wrong: Prudent Management of Endowment Funds and Imprudent Endowment Investing Policies*, 40 J.C. & U.L. 199, 202-209 (2014), available at <http://digitalcommons.pace.edu/lawfaculty/958/>.

<sup>20</sup> James Tobin, *What is Permanent Endowment Income?*, 64 AMER. ECON. REV. 427 (1974). Professor Tobin was awarded the Nobel Prize in Economic Sciences in 1981.

<sup>21</sup> Robert C. Merton, *Optimal Investment Strategies for University Endowment Funds*, in STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION 211, 211–12 (Charles T. Cotfelter & Michael Rothschild eds. 1993); See, Peter Conti-Brown, *Scarcity Amidst Wealth: The Law, Finance, and Culture of Elite University Endowments in Financial Crisis*, 63 STAN. L. REV. 699,708–09 (2011). Another view, offered by Professor Henry Hansmann, is that justifications of intergenerational equity are not persuasive and may not call for a transfer of wealth through saving from the present generation to spend on later ones. The argument for endowment accumulation should be on grounds of efficiency. Professor Hansmann suggests that the more compelling reasons for endowments are serving as a financial buffer against periods of financial adversity; helping to assure long term survival of an institution’s reputational capital; protecting intellectual freedom; and transmitting prized values. See, Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUDIES 14,39 (1990).

<sup>22</sup> See, Conti-Brown, *supra*, note 15 at 702-703. Jeffrey R. Brown, Stephen G. Dimmock, & Jin-Koo Kang, *How University Endowments Respond to Financial Market Shocks: Evidence and Implications*, 104 Amer. Econ. Rev. 931, 949-956 (2014) (Universities tend to reduce payouts relative to stated payout policies following negative shocks. In the aftermath of positive shocks, there is no evidence of changes to payouts. This may suggest endowment hoarding.)

<sup>23</sup> Center for Social Philanthropy Tellus Institute, *Educational Endowments and the Financial Crisis: Social Costs and Systemic Risks in the Shadow Banking System* 17 (2011), [hereinafter Tellus Report], available at <http://www.tellus.org/publications/files/endowmentcrisis.pdf>.

this approach; there were legal lists of securities, principally governmental securities, which were presumably safe investments in which trustees could invest.<sup>24</sup>

Endowment managers spent quite conservatively and while the “income” (e.g., dividends, interest, rent, and royalties) generated by an endowment could be currently expended, the principal of the fund remained inviolate.<sup>25</sup> In the nineteenth century, trustees invested in fixed-income securities, such as Treasury notes and secured corporate bonds while maintaining up to one third of their portfolios in real estate and mortgages.<sup>26</sup> Investment practices changed at some institutions after the First World War. In the 1920s, as the stock market rose, many endowments invested in high yielding bonds and common stocks.<sup>27</sup> The experience of the Yale endowment is illustrative. During the 1920s, the Yale endowment invested over one half of its assets in equities.<sup>28</sup> In 1930, equities represented forty-two percent of the Yale endowment portfolio, whereas the average college or university had only eleven percent.<sup>29</sup>

The Great Depression led to a more sober investment approach. In the late 1930s, Yale’s treasurer decided the share of equities in Yale’s portfolio should be reduced.<sup>30</sup> He introduced an investing template that lasted three decades: “at least two dollars would be held in fixed income instruments for every dollar of equity.”<sup>31</sup> This may have served Yale well in the 1930s and 1940s but was unsuited in the post-World War II bull markets of the 1950s and 1960s.<sup>32</sup> Yale then substantially increased its exposure to equity investments, as did other colleges and universities.<sup>33</sup> A catalyst for this change was a task force report sponsored by the Ford Foundation that concluded that most college and university endowments were too conservative in their investment policies.<sup>34</sup> The changes in endowment asset allocation did not result from a serendipitous recognition by

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<sup>24</sup> BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 11* (1986).

<sup>25</sup> Dobris, *supra* note 10, at 54–55.

<sup>26</sup> Tellus Report, *supra* note 20, at 18.

<sup>27</sup> *Id.* at 17-18.

<sup>28</sup> Josh Lerner, *Yale University Investments Office: August 2006*, 2 (Harv. Bus. School Case Study 9-807-073) (Rev. 2011).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* At this time, the Treasurer and Trustees managed the endowment themselves, selecting individual bonds and high yield stocks for the portfolio. *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> ADVISORY COMMITTEE ON ENDOWMENT MANAGEMENT, *MANAGING EDUCATIONAL ENDOWMENTS: REPORT TO THE FORD FOUNDATION* (1969). The legal impetus for the change in philosophy of investing and spending policies was another Ford Foundation sponsored report. WILLIAM E. CARY & CRAIG BRIGHT, *THE LAW AND LORE OF ENDOWMENT FUNDS* (1969).



endowment managers who had read the work of financial economists and had concluded equities over time were a sounder investment than bonds.

### *Modern Portfolio Management and Total Return Strategies*

Commencing in the late 1960s and 1970s, nonprofits faced inflation, cutbacks in government support, limitations on tuition increases at educational organizations, and in some sectors of education, a decline in demand. These developments abetted new endowment investment strategies,<sup>35</sup> one of which was more liberal spending policies through what was termed “total return policies” which permitted the expenditure of capital gains as well as traditional investment income.<sup>36</sup> Total return investing allowed charities with endowments to spend more on current needs, and they became increasingly dependent on endowment returns for the annual budget.<sup>37</sup>

Total return investing encouraged endowment trustees to move away from conservative investment strategies in favor of maximizing endowment growth. Institutions whose endowments were wholly invested in bonds or preferred stock, offering a reliable income stream, diversified their portfolios by allocating more to domestic and international equities and a wide range of alternative investments.<sup>38</sup> Concurrently, there arose an increasing use of external professional

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<sup>35</sup> Henry Hansmann, *supra* note 18, at 3,10. Though gifts remained a significant aspect to endowment growth, particularly for smaller endowments, new approaches to investing provided the engine for growth. See Fred Rogers, *Sources of Endowment Growth at Colleges and Universities* 4 (Commonfund Institute 2005), available at <https://www.commonfund.org/InvestorResources/Publications/White%20Papers/Sources%20of%20Endowment%20Growth.pdf>.

<sup>36</sup> LONGSTRETH, *supra* note 24, at 24–25. A portfolio managed under a total-return policy perspective will consider the realized and unrealized gain/loss as part of the portfolio’s performance, in addition to the yield. The total-return endowment investor can achieve greater returns than that of a buy-and-hold endowment.

<sup>37</sup> According to a 2015 Congressional Research Service Report, institutions with larger endowments use more of their endowment funds in their annual operating budget, on average. In FY2014, for institutions with endowments of \$1 billion or more, 16.9% of operating budgets were funded by endowments (the median value was 9.5%). For institutions with endowments of \$51 million - \$100 million, 6.7% of operating budgets were funded by endowments, on average (the median value was 2.6%). See, Molly F. Sherlock, Jane G. Gravelle, Margo L. Crandall-Hollick, & Jeffrey M. Stupak, *College and University Endowments: Overview and Tax Policy Options*, R444293 (Dec. 2, 2015) citing NACUBO-Commonfund Study of Endowments, 2014, p. 50, available at <https://fas.org/spp/crs/misc/R44293.pdf>. [Hereinafter *College and University Endowments: Overview and Tax Policy Options*].

<sup>38</sup> According to the 2017 NACUBO-Commonfund Study of Endowments (NCSE) a survey of 809 colleges and university endowments in the fiscal year ending June 30, 2017, the average allocation for survey participants was: 16% in U.S. stocks, 8% in fixed income, 20% in international equities, 4% in cash or short term securities, and 52% in alternative investments. For endowments of \$1 billion or more, the figures were 13% in domestic equities, 79% in fixed income, 19% in international equities, 2% in cash, and 57% in alternative investments. *Educational Endowments Report Decline in 10-Year Return Despite 12.2% Return for FY2017, Up Significantly from -1.9% Reported for FY2016*, 2017 NACUBO-Commonfund Study of Endowments 5 (hereinafter NCSE) available at

investment managers, acolytes of the principles of Modern Portfolio Theory (“MPT”), who provided the intellectual foundation for a new aggressive approach to endowment management.<sup>39</sup>

Modern Portfolio Theory provides a framework for managing an endowment’s risk through the diversification of the portfolio. No longer was the focus of risk tied to the selection of individual securities. Modern investment management examines the portfolio as a whole, rather than any given type of asset or a decision concerning that asset.<sup>40</sup>

In common parlance, risk is the chance of loss. In finance, risk refers to volatility of return.<sup>41</sup> A fundamental responsibility of an endowment board member or investment advisor is to manage the risk of the endowment’s portfolio in relation to the objectives of the fund. When an endowment’s board and its outside investment managers contend with risk, careful attention should be given to the organization’s tolerance for volatility. A diversified portfolio may contain securities across many asset classes or hold many different issuers within a particular asset class or industry. No one compensates an investor who fails to diversify. The proverb that admonishes “don’t put all of your eggs in one basket,” neatly sums up diversifiable risk.<sup>42</sup> Diversification moderates risks that are inherent in investing and reduces risks that are not justified by the

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<http://www.nacubo.org/Documents/about/pressreleases/2017-NCSE-Press-Release.pdf> .

<sup>39</sup> Tellus Report, *supra* note 20 at 19.

<sup>40</sup> *Id.*

<sup>41</sup> Financial economists use risk to describe variation when the probabilities of possible outcomes are known. Professor Lynn Stout differentiates risk from uncertainty with the following example: a coin toss is risky but not uncertain. The probability of a coin coming up heads or tails is 50%. Returns on securities, however, are both risky and uncertain. No one knows with certainty whether securities prices will go up or down or the probability of the event. Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 641 n.30 (2003). Volatility can be measured statistically by standard deviations, which indicate the degree to which an investment has varied in the course of arriving at its mean return over a given period. Investments with the greatest volatility have the highest standard deviation and should offer the greatest return.

<sup>42</sup>The phrase is very old, and its origin is unknown. In 1666, Giovanni Torriano, in the Second Alphabet of Proverbial Phrases, stated, “To put all ones eggs in a panier, viz. to hazard all in one bottom [ship],” *cited in* OXFORD ENGLISH DICTIONARY 91 (John Andrew Simpson & Edmund S.C. Weiner preparers, 2d ed. 1991). Professor John Langbein offers a more contemporary example:

[T]he investor who buys bonds issued by weaker issuers (so called junk bonds) assumes greater risk of default than the investor who only buys Treasuries. The junk bonds pay higher interest rates, compensating the investor for bearing the greater risk. But no one pays the investor for concentrating a portfolio in too small a range of asset classes or issuers. Thus, under diversification causes the portfolio to bear uncompensated risk, risk that could be largely eliminated by spreading the investments across a wider range of asset classes and issues.

John H. Langbein, *Burn the Rembrandt? Trust Law’s Limits on the Settlor’s Power to Direct Investments*, 90 B.U. L. REV. 375, 388 (2010). A recent example of the costs that failure to diversify may lead to involves the Cowboys Athletic Endowment of Oklahoma State University (“OSU”), which received a \$165 million donation from oil man Boone Pickens to transform OSU’s athletics. The endowment invested all of its assets in Pickens’ hedge fund, BP Capital, as well as in an insurance program where it purchased life insurance policies on older OSU alumni. The hedge fund lost most of its value, and OSU alumni declined to die in timely fashion. The endowment, which once had assets of \$400 million, declined to \$125 million. See Ann Zimmerman, *Boone Calls the Plays as Largess Complicates Life at Alma Mater*, WALL ST. J. July 7, 2012, at A1.

prospect of gain. A fiduciary has the responsibility of reducing or minimizing risk that can be avoided.<sup>43</sup>

### *The Endowment Model of Investing*

Beginning in the 1990s, larger endowments, primarily those with over \$1 billion in assets, undertook a new approach to portfolio management called the “endowment model of investing.” This phrase describes a theory and practice of investing characterized by a highly-diversified, long-term portfolio that differs from a traditional stock/bond mix in that it includes allocations to less-traditional and less-liquid asset categories, such as private equity and real estate, as well as absolute return strategies.<sup>44</sup>

These so-called “alternative investment” strategies include private equity, venture capital, hedge funds, distressed (or private) debt, financial derivatives as well as “real or hard assets” such as oil and natural gas, minerals, and timber.<sup>45</sup> Basically, an alternative investment is one that is not cash, stocks, or bonds—the three traditional asset classes.<sup>46</sup> They are attractive to endowments because they usually have a low correlation to traditional asset classes, which may boost overall returns. They are less regulated, transparent, and liquid than traditional asset classes, and they often have substantial minimum capital requirements and charge high fees.

Yale, Harvard, and other wealthy endowments became proponents of this widespread shift into alternative, arcane, and illiquid investments, which were in emerging, inefficient, and nontraditional markets.<sup>47</sup> The justification for this approach is explained by one of the endowment

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<sup>43</sup> UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 4(e)(4) (2006); UNIF. PRUDENT INVESTOR ACT § 3 (1994).

<sup>44</sup> JANE L. MENDILLO, HARVARD MANAGEMENT COMPANY ENDOWMENT REPORT 3 (Sept. 2010), *available at* [http://cdn.wds.harvard.edu/2010\\_endowment\\_report\\_09\\_09\\_2010.pdf](http://cdn.wds.harvard.edu/2010_endowment_report_09_09_2010.pdf). Absolute return strategies include short selling, futures, derivatives, arbitrage, leverage (borrowing or lending funds), and unconventional assets, similar to hedge funds. An absolute return strategy attempts to provide positive returns independent from markets’ movements. YALE UNIVERSITY FINANCIAL REPORT 10 (2012). Absolute strategies differ from relative strategies in that the latter seek to top a benchmark, for example, the Dow Jones Industrials.

<sup>45</sup> *College and University Endowments: Overview and Tax Policy Options*, *supra* note 32 at 14.

<sup>46</sup> *Id.*

<sup>47</sup> Institutions with larger endowments tend to have a higher share of their endowment assets invested in alternative strategies. Smaller endowment institutions tend to have most of their endowment assets invested in domestic equities, fixed income, or international equities. *Id.* at 13. An example of an alternative investment is Harvard’s 2012 purchase of three square miles of land in the central coast region of California. Ostensibly the land was used for growing grapes, but its real value was acquiring rights to vast sources of underground water, of increasing value in a state facing drought from climate change. Russell Gold, Harvard Amasses Vineyards -- and Water --- A bet on climate change in California gives it agricultural land and the rights below, *Wall St. J.* Dec. 11, 2018 at A1.

model’s most respected and successful practitioners, David F. Swenson, Chief Investment Officer of the Yale Endowment:

“Alternative assets, by their very nature, tend to be less efficiently priced than traditional marketable securities, providing an opportunity to exploit market inefficiencies through active management.”<sup>48</sup>

However, these same alternative investments may offer little transparency or liquidity, carry higher risks than traditional asset classes, and may involve speculative trading strategies.<sup>49</sup> For many years, the highest returns were earned by the largest endowments, which had access to the most sophisticated money managers and the in-house expertise to evaluate a complex mix of alternative investments. As the table below indicates, Harvard’s endowment increased in the 1987 to 2007 period by 762%, Princeton’s by 589% and Yale’s by 974%. In the period 2001 to 2007 higher education endowments grew annually by double digit figures.

**Table 2**  
**Increase in Assets of Leading Endowments 1987-2007**

School	1987 Endowment	2007 Endowment	Percentage Increase
Harvard	4,018,270,000	34,634,906,000	762%
Yale	2,098,400,000	22,530,200,000	974%
Stanford	1,676,950,000	17,164,836,000	924%

<sup>48</sup> YALE ENDOWMENT REPORT 2010, *supra* note 38, at 9. Alternative investments include hedge funds, which traditionally were pools of capital used to purchase securities on both sides of a market risk. Today, the term connotes any lightly regulated investment pool that engages in a wide range of investment strategies, some of which are high-risk, which seek to generate superior long-term returns by exploiting market inefficiencies. Alternative investments also include private equity, such as venture capital and leveraged buyout funds, which take stakes in start-up businesses or buy firms primarily with borrowed money in the hope of cashing out at a later time when the firm is acquired by another company or goes public. The largest endowments also achieve diversification by investing in real assets, such as real estate, oil and gas, and timber.

<sup>49</sup> Tellus Report, *supra* note 17. At 20. Investors demand a premium for placing assets in an illiquid investment. The illiquidity premium refers to the fact that the investment cannot quickly be converted to cash. *See* Conti-Brown, *supra* note, 15 at 729. In times of financial need or extreme stress in the markets, an illiquid investment cannot be turned into cash except at a great loss or not at all. The advantage of illiquid investments is that the holder does not have to pay a liquidity premium as part of the price, thereby increasing the return on the investment. Those who may need cash in the short term cannot commit to such long term investments. From a long term perspective, this works well, but if any of the illiquid funds are needed in the present as they were in 2008 and cannot be obtained, the university will have to borrow or cut the budget or both. *See id.* at 731–32.

Princeton	2,291,110,000	15,787,200,000	589%
University of Texas	2,829,000,000	15,613,672,000	451%
MIT	1,169,740,000	9,980,410,000	753%
Columbia	1,387,060,000	7,149,803,000	415%
University of Michigan	287,539,000	7,089,830,000	2366%
University of Pennsylvania	648,528,000	6,635,187,000	923%
Texas A+M*		6,590,300,000	-

\*Combined with University of Texas Endowment at time. One third benefitted Texas A+M.

**II. Congressional and Academic Scrutiny**

*The Largest Endowments Come under Criticism*

Criticism of large charitable endowments is nothing new. Forty-five years ago, the Sun newspapers of Omaha, Nebraska discovered that Father Flanagan’s Boys Town, which runs group homes for troubled adolescents, was sitting on a \$209 million-and-growing endowment even as it cast itself as operating in Dickensian poverty. The newspapers won the 1973 Pulitzer Prize for local reporting and were owned by a local investor named Warren Buffet, who helped reporters decipher Boys Town’s finances. The articles sparked changes and increased transparency at the charity.<sup>50</sup>

Ballooning college endowments have similarly faced increased scrutiny by Congress. A Senate hearing in September, 2007 on Offshore Tax Issues: Reinsurance and Hedge Funds discussed large educational endowments’ use of so-called “blocker corporations” in foreign transactions to avoid payment of unrelated business income taxes (UBIT).<sup>51</sup> Among those testifying were Dr. Jane Gravelle of the Congressional Research Service and Lynne Munson of

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<sup>50</sup> It remains one of the richest such organizations with an endowment now topping \$900 million. See, Megan O’Neill, *From Boys Town to Harvard: Big Endowments in the Cross Hairs*, Chron. Phil. Aug. 1, 2017 available at: <https://www.philanthropy.com/article/From-Boys-Town-to-Harvard-Big/240771?elqTrackId=13de749a86eb4e1eab831ec0aaf0f22e&elq=99ca044fae9e4dacb7828faeaf090f9&elqaid=16196&elqat=1&elqCampaignId=7002>.

<sup>51</sup> Tax exempt investors and foreign investors often set up offshore feeder corporations known as a blocker corporation when they invest in private equity or hedge funds in order to avoid U.S. trade or business income tax. NASDAQ Investing Glossary, available at <http://www.nasdaq.com/investing/glossary/b/blocker-corporation>. See *infra*, p. 17 n.65.

the Center for College Affordability.<sup>52</sup> Dr. Gravelle urged an increase in endowment spending to reduce tuition and suggested that taxes be imposed on educational institutions that increased their tuition by more than an appropriate rate such as inflation or the Consumer Price Index.<sup>53</sup> Though no legislation resulted, Senator Charles Grassley (R- Iowa) began asking why colleges with the largest endowments had the highest tuition, which was increasing at a greater rate than inflation, and spent so little.<sup>54</sup> In 2007, he suggested that large endowments should have a mandatory five percent payout, the same figure that applied to private foundations.<sup>55</sup>

In January 2008, the Senate Finance Committee via a letter from Senators Max Baucus (D-Mont.) and Grassley requested detailed information from colleges with endowments of \$500 million or more about their tuition, financial aid, year by year endowment growth, investment returns, and fees paid to investment advisers. The Senators' letter came one day after the National Association of College and University Business Officers annual survey showed that the 76 educational institutions with endowments of \$1 billion or more saw their endowments rise by 21% from the previous fiscal year with an average payout of 4.4 percent<sup>56</sup> In a widely distributed comment, Senator Grassley said:

“Tuition has gone up, college presidents' salaries have gone up, and endowments continue to go up and up. We need to start seeing tuition relief for families go up just as fast. It's fair to ask whether a college kid should have to wash dishes in the dining hall to pay his tuition when his college has a billion dollars in the bank”.<sup>57</sup>

In reaction to Congressional pressure urging colleges and universities to increase endowment spending to assist families in meeting the costs of higher education, several of the wealthiest U.S. colleges in 2007 and 2008 changed their financial aid policies, awarding grants

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<sup>52</sup> Statement of Dr. Jane G. Gravelle, Offshore Tax Issues: Reinsurance and Hedge Funds Hearing Before The Committee On Finance United States Senate One Hundred Tenth Congress First Session September 26, 2007 available at <https://www.finance.senate.gov/imo/media/doc/515631.pdf>. The American Council on Education, which was not invited to testify at the hearing, responded that this was federal price control that would put government in the market of college pricing decisions.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> See, Ann Marie Chaker, *Some Colleges Cut, Eliminate Student Debt --- Soaring Tuition, Pressure To Spend Endowments Spur Schools to Offer More Grants*, Wall St. J. Nov. 29, 2007 at D1. See, I.R.C. 4942(e)(1), which requires private foundations to spend at least five percent of their current investment asset value for charitable purposes annually.

<sup>56</sup> Karen W. Aronson, *Senate Looking At Endowments As Tuition Rises*, N.Y. Times, Jan. 25, 2008 at A1.

<sup>57</sup> Doug Lederman, *Senators Scrutinize Well-Endowed Colleges*, Inside Higher Ed. (Jan. 25, 2008) available at <https://www.insidehighered.com/news/2008/01/25/senators>. The author's first job in college was washing dishes in a dining hall.

that did not need to be repaid instead of loans. Among the schools that adopted the so-called “no-loan” policies were all of the Ivy League, Swarthmore College and Pomona College. Princeton University had adopted the policy years before. Other schools increased scholarship aid or raised the income eligibility for grants to enable students from modest means to attend.<sup>58</sup>

In February 2008, the House, with bipartisan support, passed the higher Education Opportunity Act, which would establish a federal list of the most expensive colleges. Members of both parties favored fighting rising college tuition. An amendment that would have required colleges to spend five percent of their assets each year was withdrawn, but another amendment passed by a voice vote and required colleges to report how much of their endowments they spend to keep students’ costs down.<sup>59</sup>

### *The Market Drop of 2009*

In the fiscal year ending June 30, 2008, higher education endowments lost three percent of their value in a difficult financial environment. Then the bottom dropped out. The nation's most severe financial crisis since the Great Depression occurred in fall 2008. This event wreaked havoc on endowment portfolios. By the end of the 2009 fiscal year, Harvard's endowment was \$25.7 billion (down 29.8% from the previous year), followed by Yale's at \$16.3 billion (down 28.6%), and Princeton's \$12.6 billion (down 22.8%).<sup>60</sup> A survey of over 800 higher education institutions showed losses on average of 18.7%, the worst rate of return since the Great Depression.<sup>61</sup> Layoffs, buyouts, hiring freezes, and cancelled construction plans followed. This period of losses quieted the clamor over endowment hoarding and tuition relief.

One development that emerged from the market drop was that the largest endowments allocated an increased amount of endowment spending to the annual operating budget. For example, in 2017 endowments contributed to 36% of Harvard's budget, 34% of Yale's budget,

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<sup>58</sup> Chaker, *supra* note 46.

<sup>59</sup> HR 4137, Higher Education Opportunity Act, H. Amend. 944, 110<sup>th</sup> Cong (2007-2008); Jonathan D. Glater, *House Bill Aimed at College Costs*, N.Y. Times, Feb. 8, 2008 at A13.

<sup>60</sup> Tamar Lewin, *Investment Losses Cause Steep Dip in University Endowments, Study Finds*, N.Y. TIMES (Jan. 28, 2010), [http://www.nytimes.com/2010/01/28/education/28endow.html?\\_r=0](http://www.nytimes.com/2010/01/28/education/28endow.html?_r=0). Although the declines were the greatest since the Depression, those endowments had only fallen to their 2005 levels, and they had positive returns over the ten years ending on June 30, 2009.

<sup>61</sup> Kenneth E. Redd, *To Ensure We Endure*, BUSINESS OFFICER, July/August 2012, *available at* [http://www.nacubo.org/Business\\_Officer\\_Magazine/Magazine\\_Archives/JulyAugust\\_2012/To\\_Ensure\\_We\\_Endure.html](http://www.nacubo.org/Business_Officer_Magazine/Magazine_Archives/JulyAugust_2012/To_Ensure_We_Endure.html).

and a whopping 61% of Princeton's budget.<sup>62</sup> This meant that endowments were not really rainy day funds but were instead means of generating income for institutions' current needs.

### *Recovery and Renewed Criticism*

In the aftermath of the 2008 market drop, securities prices recovered, and by 2015 the largest endowments made back much of their losses and stockpiled their recent gains. The *Chronicle of Philanthropy* examined four years of endowment data from the commencement of the 2010 fiscal year through the end of the 2015 fiscal year and found that nonprofits were increasing their endowments much faster than they were spending their gains.<sup>63</sup> Harvard's endowment increased from \$25.3 to \$36.4 billion (a 44% increase); Princeton's endowment almost doubled from \$11.6 to \$22.1 billion (a 90% increase), and Yale's endowment went from \$16.5 to \$25.8 billion (a 56% increase).<sup>64</sup> Their spend rates ranged from 4%-5% annually.

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<sup>62</sup> Harvard University Financial Report Fiscal Year 2017 at 5; Report of the Treasurer, Princeton University 2017 at 13; Yale University Financial Report 2016-2017, at 14. According to the 2015 CFR report institutions with larger endowments use a greater percentage of endowment funds in their annual operating budget on average than smaller endowments. In FY2014, for institutions with endowments of \$1 billion or more, 16.9% of operating budgets were funded by endowments (the median value was 9.5%). For institutions with endowments of \$51 million - \$100 million, 6.7% of operating budgets were funded by endowments, on average (the median value was 2.6%). See NACUBO-Commonfund Study of Endowments, 2014, p. 50. *College and University Endowments: Overview and Tax Policy Options*, *supra* note 32 at 11n.26.

<sup>63</sup> 2010-2015 Megan O'Neil and Joshua Hatch, *Many Big Nonprofits Rapidly Stockpiling Endowment Cash*, *Chronicle Data Shows*, *Chron. Phil.* July 26, 2017 available at: <https://www.philanthropy.com/article/Many-Big-Nonprofits-Rapidly/240753?elqTrackId=6aa3704c8c614443b253f5fe18c30d28&elq=9d1b75ad1e08485e905dc95d5796c022&elqaid=16399&elqat=1&elqCampaignId=7094.>]

<sup>64</sup> *Id.* By 2017 Harvard's endowment increased to \$37.1 billion (46.6%), Princeton to \$23.8 billion (105%) and Yale to \$27.176 billion (63.2%). Investment income is only one source of endowment growth. Contributions to the institution, operating surpluses, and other revenue streams are placed in the endowment. In fiscal 2017 Harvard received \$550 million in endowment gifts from its current capital campaign. John S. Rosenberg, *Endowments: The Specter of Taxation*, *Harv. Magazine*, Nov. 6, 2017 available at <https://harvardmagazine.com/2017/11/taxing-university-endowments>.



**Table 3**  
**Growth of Endowments 2007-2017**

	2007	2017	Percentage Increase <sup>65</sup>
Harvard	\$34.635 Billion	\$37.1	7.1%
Princeton	\$15.787	\$23.812	50.8%
Yale	\$22.530	\$27.176	20.6%

**Table 4**  
**Growth of Endowments 1987-2017<sup>66</sup>**

Harvard	\$4.02 Billion	\$37.1	823%
Princeton	\$2.29	\$23.812	940%
Yale	\$2.10	\$27.176	1194%

Despite the largest endowments' growth in assets, their post-2009 investment prowess was not consistently successful. Annual returns were volatile, and there was substantial variation in the rate of return from year to year. The latest NACUBO-Commonfund survey of 809 U.S. colleges and universities for the 2017 fiscal year indicated that while participating institutions'

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<sup>65</sup> 2010-2017 Harvard, Princeton, Yale Financial Reports.

<sup>66</sup> Source 2007, 2017 NACUOBO Studies of Endowments, 2007, 2017, NACUOBO Archives, available at <https://www.nacubo.org/research/2018/nacubo-commonfund-study-of-endowments>.

endowments returned an average of 12.2% (net of fees) compared with -1.9% for the fiscal year 2016. the standard ten year look back, or trailing ten year average, for all educational endowments was only 4.6%.<sup>67</sup> Harvard's ten year return was but 4.4%; Princeton's ten year return was 7.3%, and Yale's ten year return was 6.6%.<sup>68</sup> The 4.6% ten year average returns lagged behind the old fashioned 60-40 or 70-30 equity/fixed income allocation ratios, which returned 5.3% and 5.4% respectively.<sup>69</sup> These returns call into question the endowment model of investing that relies heavily on alternative investments.<sup>70</sup>

Though the size of the over-\$1 billion endowments grew at a greater pace than the smaller endowments, their spend rates remained roughly the same.<sup>73</sup> Percentage wise, there is little difference in spend rates between endowment sizes, save for the very smallest endowments.<sup>70</sup> Small differences in spending rates occurred by size of endowments and type of endowment.<sup>71</sup> The spending rate for all 809 institutions in the 2017 NACUBO-Commonfund survey was 4.4%.<sup>72</sup> The average payout was greater for private institutions (4.6%) than public ones (4.1%); there is a wider distribution of payouts by size of endowment.<sup>73</sup>

Despite relatively small differences in spending rate between endowments on the basis of investment by virtue of its size a larger endowment will have more dollars to spend after it receives its returns on investment by virtue of its size.<sup>74</sup> Congressional criticism reemerged over the failures of these immense funds to be used for tuition relief and other worthy purposes, such as increasing the number of underrepresented constituencies at these institutions.

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<sup>67</sup> 2017 NACUBO-Commonfund Study of Endowments, *supra* note 38.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> James B. Stewart, *College Endowments Opt for Alternative, and Less Lucrative, Route; Common Sense*, N.Y. Times, Feb. 23, 2018 at B1. For the 97 endowments with over \$1 billion in assets, the average 2017 ten year fiscal return was 5%. The average five year return for the billion dollar endowments was 8.6%. For the 60-40 equity fixed income ratio, the return was 8.2% and the 70-30 ratio, 9.2%. Despite the mixed ten year returns, proponents of the endowment model of investing maintain that ten years is an insufficient time period to judge its worth. James B. Stewart, *Returns Lag, but Ivy Colleges Cling to Investment Strategy*, N.Y. Times, Dec.13, 2018 at B3.

[Footnotes missing]

<sup>74</sup> Though the investment growth rate of an endowment may be lower than average, the larger the endowment, the greater in size will be the absolute growth in dollars compared to a smaller endowment. Assume a billion dollar endowment grows 4.4% in one year, and a \$500 million endowment grows at a 4.8% rate. The billion dollar endowment will increase by \$44 million after one year; the \$500 million endowment will increase by \$24 million.

In 2014, Representative David Camp (R-Mich.), then the Chair of the House Ways and Means Committee, included as part of his comprehensive tax plan to overhaul the Tax Code, which became the template for the Tax Reform Act of 2017,<sup>75</sup> a proposed a one percent excise tax on the net investment income of universities with endowment assets worth \$100,000 per student. A House panel in 2015 further examined college endowment spending and the tax benefits received. Among the suggestions discussed was one by Representative Tom Reed (R-N.Y.), who proposed, but did not introduce, legislation that would mandate that colleges with over \$1 billion endowments allocate 25% of their investment earnings to tuition relief as a condition of tax-free status for the endowment. He further suggested that wealthy universities such as Yale University and Harvard University, whose investment management firms can earn billions in returns annually, also distribute their unused excess funds to other institutions.<sup>76</sup>

Representative Reed's bill ignored the differences in universities with large endowments, their financial aid policies, investment strategies, the difficulty of valuing illiquid investments, and economic situations of schools in the billion-dollar endowment club. Furthermore, it would have been difficult to find a better way to cut off alumni and other donor support than the idea of transferring endowment funds from one institution to another. Unsurprisingly, Reed's proposal went nowhere beyond press coverage.<sup>77</sup>

In February 2016, the Senate Finance Committee and the House Ways and Means Committee sent letters to 56 private schools with assets greater than \$1 billion.<sup>78</sup> The letter signed by Senator Orrin Hatch (R-Utah) and Representatives Kevin Brady (R-Tex.) and Peter

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<sup>75</sup> Public Law No: 115-97 (12/22/2017).

<sup>76</sup> Janet Lorin & Lauren Streib, *House Panel Questions College Endowment Spending, Tax Benefits*, Bloomberg, Oct. 7, 2015 available at <https://www.bloomberg.com/news/articles/2015-10-07/house-panel-questions-college-endowment-spending-tax-benefits>.

<sup>77</sup> Representative Reed introduced legislation in May 2018 that would waive the new tax if they spend 25 percent of their annual investment earnings on reducing the cost for middle-income students. All schools would have to reveal more details about pay and investment manager fees and submit cost-containment plans to the Treasury Department every five years to show how they will keep increases below inflation. There are no co-sponsors. Janet Lorin, *Rich College Endowments May Get Tax Break If They Spend Enough*, Bloomberg, May 22, 2018, <https://www.bloomberg.com/news/articles/2018-05-22/bill-waives-tax-on-rich-college-endowments-if-they-spend-enough>.

<sup>78</sup> Janet Lorin, *Rich Schools Queried by U.S. Lawmakers on Endowment Spending*, Bloomberg, Feb. 9, 2016 available at: <https://www.bloomberg.com/news/articles/2016-02-09/richest-schools-queried-by-u-s-lawmakers-on-endowment-spending>]

Roskam, (R-Ill.) posed thirteen sets of questions including fee arrangements, how investment income was spent for the past three years and data about how much of the investment return was spent on financial aid.<sup>79</sup> In a separate statement Senator Hatch said the letters will allow Congress to learn more about how university endowments use their tax preferences to fulfill their charitable purposes.<sup>80</sup>

The large endowments did not help themselves in a public relations sense when it became widely known in mid-2017 through the International Consortium of Investigative Journalists' publication of the so-called "Paradise Papers" that the largest endowments had invested in tax avoidance strategies in off shore havens such as the Cayman Islands through the use of "blocker corporations".<sup>81</sup>

While endowments are tax exempt, when they partner with private equity and hedge fund firms that use borrowed money to fund their investments, they may be subject to the Unrelated Business Income Tax (UBIT) for income from debt-financed investments.<sup>82</sup> To avoid this taxation and the fact that many of these investments, such as in fossil fuels or open pit mining operations, would be politically incorrect on campus, the endowments established as intermediaries between themselves and their investing partners blocker corporations that served to block the taxable income that might flow to the endowments. The blocker corporation is incorporated in a low tax or no tax jurisdiction.<sup>83</sup> Not surprisingly, endowments that use this technique, which avoids millions of dollars in taxes that would flow to the U.S. Treasury, do not advertise this strategy. The widespread disclosure of this device fed the hostility to higher education and did not help the endowments' efforts in opposing the new tax legislation.

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<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> See, Stephanie Saul, *Endowments Rise as Schools Bury Earnings*, N.Y. Times, Nov. 7, 2017 at A1.

<sup>82</sup> If an exempt organization borrows in order to acquire income-producing property, all of that income, less allowable deductions may be included as unrelated business taxable income under I.R.C. § 514.

<sup>83</sup> See, Saul, *supra* note 85. Any investment income the tax-exempt receives is in the form of a dividend from the blocker corporation, rather than income flowing directly from the hedge fund. Since it is a corporate dividend, there are no UBIT consequences—in other words, the use of the corporation essentially "blocks" any income subject to UBIT from flowing through the hedge fund to the tax-exempt investor. Furthermore, in order to avoid tax consequences for the blocker corporation, these entities are generally established in low or zero tax countries, such as the Cayman Islands. The blocker corporation will then owe little or no tax to its home country, and it will typically have minimal or no U.S. tax liability since it is a foreign corporation operating outside the United States. See IRC §881. *College and University Endowments: Overview and Tax Policy Options*, *supra* note 32 at 16.

## *Academic Inquiry of Large Endowments*

### *Taxing Endowment Investment Income*

With less publicity, the academic community began to examine large endowments from several perspectives: in terms of tax policy, should endowment investment income be taxed? Could and should tuition be reduced? Should spend rates be increased? What should be the balance between accumulation for future needs and increased expenditures for current demands, and which can have a greater impact for the future?

In three thoughtful articles, Professor Daniel Halperin examined tax policy and endowments.<sup>84</sup> He concluded that while exemption for contributions or gifts is consistent with a normal income tax, exemption for investment income is not.<sup>85</sup> Income tax exemption for investment income of charities is a departure from normal tax privileges and is a subsidy.<sup>86</sup> Whether a subsidy exempting investment income from tax is desirable depends on the degree to which one believes the tax system should help channel long-term savings through endowments.<sup>87</sup> However, if it is believed that under the current system, endowments and charitable savings are likely to be larger than the public interest would suggest, there may be a case for the tax system to place a thumb on the scale in favor of current spending or at least limit the subsidy for excessive accumulation.<sup>88</sup>

In arguing in favor of a tax on investment income, Professor Halperin believes that endowments are likely to be larger than the public intent would suggest for three reasons. First, it is likely that trustees, donors, and key employees have a bias for accumulating funds as opposed to current spending, which will not necessarily reflect the interest of the institution, let alone the public. Second, the apparent goal to ensure continuation of the level of the contribution to program support from the endowment, without regard to market performance or the likelihood of future gifts, seems to unduly set aside current resources for use by future generations. Contributions, he maintains, are likely to continue and, if they do not, this may signal lack of support for the charitable purpose. Third, there appears to be a tendency, or at least a desire,

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<sup>84</sup> Daniel Halperin, *Is income Tax Exemption for Charities a Subsidy?*, 64 *Tax Law Review* 283 (2011); *Tax Policy and Endowments—Is Excessive Accumulation Subsidized?*, 67 *Exempt Org. Tax Rev.* 17 (Jan. 2011); and *Tax policy and Endowments—Is Excessive Accumulation Subsidized? (Part II)* 67 *Exempt Org. Tax Rev.* 125 (Feb. 2011).

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Tax Policy and Endowments—Is Excessive Accumulation Subsidized*, *supra* note 67 at 310.

toward increasing the share of the budget provided from an endowment, perhaps to increase the competitive advantage of richer institutions, which also does not appear to reflect the public interest.<sup>89</sup> During the market break of 2009, large accumulation endowments did not necessarily make the institution better able to handle the disruption. An unlimited subsidy for charitable accumulation, concludes Professor Halperin, is unlikely to be an efficient and equitable use of limited government resources.<sup>90</sup>

Professor Edward A. Zelinsky believes there is a strong tax policy argument for taxing the net investment income of all charitable endowments no matter their size, and that section 4968 is best defended in political terms as an incremental step towards the kind of comprehensive tax on all charitable endowments suggested by conventional tax policy criteria.<sup>91</sup> He bases the case for taxing all endowments on the logic of analogy: the charitable entities that today are not taxed are similar to the corporations and charitable entities that are taxed.<sup>92</sup> Hence, by analogy, these other charitable endowments, including all educational endowments no matter how small, should be taxed for revenue purposes as are corporations and private foundations.<sup>93</sup> This is justified, he maintains, because all charitable endowments use social overhead and have capacity to pay to the tax. Similar entities should be taxed similarly.<sup>94</sup>

The tax code is rife with inconsistencies, often for social policy reasons. Consistency aside, the justification for section 4968, though not visible in the enacted product, was the belief that the largest educational endowments were hoarding instead of spending, which allowed their schools' tuition to rise unreasonably, increased the inequality between educational institutions, and created an inability of non-large endowment schools to compete for students or faculty.<sup>95</sup> For small endowments there is a justification for the extra subsidy providing exemption from tax on investment income, a need which Congress found does not exist for the billion dollar endowments. Congress has enormous leeway to structure tax legislation as it sees fit.<sup>96</sup> The net

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<sup>89</sup> *Tax policy and Endowments—Is Excessive Accumulation Subsidized? (Part II)*, *supra* note 60.

<sup>90</sup> *Id.*

<sup>91</sup> Edward A., Zelinsky, *Section 4968 and Taxing All Charitable Endowments: A Critique and Proposal*, 38 Va. Tax Rev. 141 (2018).

<sup>92</sup> *Id.* at 142-143

<sup>93</sup> *Id.*.

<sup>94</sup> *Id.*

<sup>95</sup> Lorin & Streib, *supra* note 80.

<sup>96</sup> *Regan v. Taxation with Representation*, 461 U.S. 540 (1983). In *Regan* the Court unequivocally stated that the tax exemption and charitable deduction are a “form of subsidy that is administered through the tax system” having

income exemption for smaller endowments is a modest effort to reduce the inequalities between educational institutions and their students.

### *Endowment Spending Policies*

Endowment spending policies have been matters of widespread academic commentary and disagreement.<sup>97</sup> The average spend rate of all institutions in the 2017 NACUBO-Commonfund Survey was 4.4%, for the billion dollar endowments 4.8%.<sup>98</sup> Harvard's 2017 spend rate was 5.4%, Princeton's 5%, and Yale's 5.25%.<sup>99</sup> The academic viewpoint is largely in favor of increased current spending as opposed to holding assets for the future rainy day.

Professor Halperin finds mandatory spend rates intrusive and not necessarily effective. He suggested a tailored tax on investment income to encourage current spending, but in any event to reduce the tax subsidy for excessive accumulation.<sup>100</sup> He also proposed the limit on the charitable deduction for at least some gifts to endowments should be reduced to at least to the

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“much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.”<sup>96</sup> Under this theory, Congress has great authority in fashioning tax legislation. It can give the privilege of exemption, and take it away. Indisputably, Congress has a legal right to impose an investment income excise tax on some endowments and to retain an exemption for others.

<sup>97</sup> See RAY D. MADOFF, IMMORTALITY AND THE LAW 96-109 (2010); RICHARD POSNER, ECONOMIC ANALYSIS OF THE LAW, § 18.5 (7th ed. 2007); Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 725 (1999); Brown et. al. supra note 19; Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997); Peter Conti-Brown, *Scarcity Amidst Wealth: The Law, Finance, and Culture of Elite University Endowments in Financial Crisis*, 63 STAN. L. REV. 699, 741-43 (2011); Brian Galle, *Pay It Forward? Law and The Problem of Restricted-Spending Philanthropy*, 93 WASH. U. R. L. EV. 1143 (2016); Henry Hansmann, supra note, 18 at 3, 40; Sarah E. Waldeck, *The Coming Showdown Over University Endowments: Enlisting the Donors*, 77 FORDHAM L. REV. 1795 (2009); Daniel Halperin, *Is Excessive Accumulation Subsidized?*, supra note 60; Daniel Halperin, *Is Excessive Accumulation Subsidized?* (Pts. I & II), supra note 67; Calvin H. Johnson, *Payout by Charities Over 50 Years*, *Tax Notes*, Sept. 12, 2011 at 1161; Akash Deep and Peter Frumkin, *The Foundation Payout Puzzle* (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 9, 2005), available at <http://ssrn.com/abstract=301826>. From the political world, Senator Charles Grassley has weighed in by supporting a 5% mandatory payout of educational endowments to reduce the high costs of tuition and improve access to the middle class and poor. See Karen W. Arenson, *Big Spender*, N.Y. Times (Apr. 20, 2008), <http://query.nytimes.com/gst/fullpage.html?res=9F02EED91E3DF933A15757C0A96E9C8B63&ref=karenwarensen>.

<sup>98</sup> The effective spending rate represents the distribution for spending divided by the beginning market value of the endowment on or around the beginning of the fiscal year. The distribution for spending is the dollar amount withdrawn from the endowment to support expenditures on student financial aid, faculty research, maintenance of facilities, and other campus operations, as determined and defined by each institution. The rate is calculated net of investment fees and expenses for managing the endowment. 2017 NACUBO-Commonfund Survey, supra note 33.

<sup>99</sup> Harvard Financial Report supra note 53, at 34; Princeton Treasurer's Report, supra note 53, at 16; Yale Financial Report, supra note 53, at 17.

<sup>100</sup> Halperin, *Tax policy and Endowments—Is Excessive Accumulation Subsidized? (Part II)*, supra note 67.

level applicable to gifts to private foundations,<sup>101</sup> and recommended an examination whether the current tax law encourages excessive borrowing.<sup>102</sup>

Victor Fleischer, then a University of San Diego law professor, wrote a widely noticed opinion piece in the New York Times, “Stop Universities from Hoarding Money”, where he reviewed in detail Yale’s 2014-2015 financial report.<sup>103</sup> He found that the Yale endowment paid \$480 million to private equity fund managers as compensation--\$137 million in annual management fees and another \$343 million in performance fees to manage \$8 billion, one third of Yale’s endowment. The danger of investing so much with private equity and hedge funds is the potential volatility of their returns. Of the \$1 billion the endowment contributed to the University’s operating budget, only \$170 million was earmarked for tuition assistance. Professor Fleischer contended that instead of holding down tuition, endowments were hoarding money and suggested that universities spend at least eight percent of their endowments annually.<sup>104</sup>

Fleischer maintained that Yale’s payments to private equity firms, many with Yale connections, have made them the primary beneficiaries of the institution’s endowment.<sup>105</sup> His argument for increased spending underplays the volatility of large endowment investment policies, which makes an eight percent payout risky, and at an amount above the Uniform

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<sup>101</sup> Other scholars have gone further. Sarah Waldeck recommended denying a charitable deduction for some gifts. See, Waldeck, *supra* note 75, at 1818-1822. Herwig Schlunk recommends a tax on investment income and a denial of a charitable deduction if the donee is prohibited from spending the given funds immediately, See, Herwig Schlunk, *Why the Charitable Deduction for Gifts to Educational Endowments Should Be Repealed*, 71 U. Miami L. Rev. 702 (2017).

<sup>102</sup> Halperin, *Tax policy and Endowments—Is Excessive Accumulation Subsidized? (Part II)*, *supra* note 67.

<sup>103</sup> See, Victor Fleischer, *Stop Universities From Hoarding Money*, N.Y. Times, Aug. 19, 2015, available at: <https://www.nytimes.com/2015/08/19/opinion/stop-universities-from-hoarding-money.html>.

<sup>104</sup> *Id.*

<sup>105</sup> Yale’s response was that fee bashers miss the most important metric is net returns, not gross fees. See, Janet Lorin, *Yale Endowment Blasts Low-Fee Critics, Says Gains Would Lag*, Bloomberg, April 9, 2007, available at <https://www.bloomberg.com/news/articles/2017-04-09/yale-endowment-blasts-low-fee-crusaders-says-returns-would-sag>. A Detroit Free Press investigation found Executives at some of the nation's top investment firms donated hundreds of millions of dollars to the University of Michigan while the university invested as much as \$4 billion in those companies' funds. See, Matthew Dolan & Jason Jesse, *Univ. of Michigan pours billions into funds run by contributors' firms*, Detroit Free Press (Feb. 1, 2018) available at <https://www.freep.com/story/news/local/michigan/2018/02/01/university-michigan-endowment-donor-funds/1066143001/?elq=cbc0d4d6ca244ca084e4c35f8bde661a&elqCampaignId=7799&elqTrackId=f36fd1ba4986494aa34f3dd61ee9431b&elqaid=17711&elqat=1>.



Management of Institutional Funds Act's recommended maximum spend rate of seven percent.<sup>106</sup>

To increase the returns in a low interest environment is to increase the risk of the investment. The largest endowments have earned the greatest rewards, but the annual volatility of the investment returns contrasts with the idea that endowments are supposed to provide a constant stream of income. The 2009 market decline confirms that idea, and the recovery in endowment values from 2010 to 2017 was not guaranteed.

Professor Evelyn Brody suggests that organizations should compare the social benefits of current spending with the potential benefit of future spending, accounting for both the likelihood of future contributions and intergenerational equity between current donors and the ultimate beneficiaries.<sup>107</sup> Professor Brian Galle, in a study of the restricted spending policies of private foundations, argued that restricted spending sacrifices crucial information, leaves superior opportunities on the table, and on average transfers funds to times when they are less useful. While there is a place for large and long-lived philanthropic organizations in American society, that role does not require public support for restricted spending. As long as foundations can demonstrate their value to new donors, they will continue to thrive. His analysis can be readily applied to large endowments. Professor Galle suggests that by not spending now, institutions forego investment returns that are bigger than the dollar returns that organizations obtain from investing their money. Given the increasing inequality in American higher education, endowments should open the spigots to combat it.<sup>108</sup>

### **III. The Endowment Excise Tax**

#### *The House Bill and the Reaction of the Institutions Affected*

The House proposed tax reform bill was far more punitive to higher education than the final legislation.<sup>109</sup> It taxed tuition benefits for employees, graduate students and employees'

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<sup>106</sup> The Uniform Prudent Management of Institutional Funds Act §4(d)(2006) provides that spending in excess of a firm's assets would be presumptively a violation of the manager's duty of care to the organization, though it has only been adopted in fifteen states.

<sup>107</sup> Brody, *Charitable Endowments and the Democratization of Dynasty*, *supra* note 75.

<sup>108</sup> Brian Galle, *supra* note 75.

<sup>109</sup> Tax Cuts and Jobs Act, H.R.1, 115<sup>TH</sup> Cong. (2017). *See*, Nick Anderson, *Tax bill reflects rift between many Republicans and higher education*, Wash. Post, Nov. 19, 2017 available at

dependents.<sup>110</sup> Deductions for student loans, interest, and tax-free financing for private college and university capital projects would be eliminated.<sup>111</sup> The original endowment excise tax was a 2% levy on institutions with \$250,000 of endowment per full time equivalent students, which would have affected over 200 educational institutions.<sup>112</sup> The Senate bill and the final legislation retained the House bill's provision that refinancing capital projects would make the interest taxable. Ultimately, the endowment excise tax was reduced to 1.4% and triggered when the endowment per student ratio reaches \$500,000.<sup>113</sup>

Unsurprisingly, the higher education community was against the excise tax. While some elements of the education community were valid, others were unpersuasive. The first argument against the House plan was that it would lead to a reduction in scholarship assistance and diminish the resources available for teaching and research. That is unlikely, because even during the market drop of 2009, scholarship assistance was protected, and surely the proposed level of the tax would not affect the ability of almost all of the affected universities to meet existing budget commitments for student aid. To suggest the tax will force institutions to cut back on their scholarships is likely false, except for a very few small institutions with large endowments primarily used to fund financial aid.<sup>114</sup>

Another argument was that most institutional endowment assets were restricted funds with limited flexibility and cannot be used for financial aid. That may be true, but some of those

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[https://www.washingtonpost.com/local/education/tax-bill-reflects-rift-between-many-republicans-and-higher-education/2017/11/19/33f52a6e-cb0c-11e7-aa96-54417592cf72\\_story.html?utm\\_term=.660f04cc1265](https://www.washingtonpost.com/local/education/tax-bill-reflects-rift-between-many-republicans-and-higher-education/2017/11/19/33f52a6e-cb0c-11e7-aa96-54417592cf72_story.html?utm_term=.660f04cc1265).

<sup>110</sup> *Id.* at § 1203.

<sup>111</sup> *Id.* at § 1204

<sup>112</sup> *Id.* at § 5103. Section 5206 of Representative Dave Camp's discussion draft of the Tax Reform Act of 2014, (Feb. 21, 2014), the template for the House's tax reform bill two years later, provided that a 1% investment income tax be applied to institutions with an asset per student ration of \$100,000. A Bill to amend the Internal Revenue Code of 1986 to provide for comprehensive tax reform. Discussion Draft, 113th Congress 2d Session §5206 available at

[http://waysandmeans.house.gov/UploadedFiles/Statutory\\_Text\\_Tax\\_Reform\\_Act\\_of\\_2014\\_Discussion\\_Draft\\_\\_022614.pdf](http://waysandmeans.house.gov/UploadedFiles/Statutory_Text_Tax_Reform_Act_of_2014_Discussion_Draft__022614.pdf). This would have affected an estimated 140 schools. *See*, Ben Myers & Brock Read, *If Republicans Get Their Way, These Colleges Would See Their Endowments Taxed*, Chron. Higher Educ. Nov. 2, 2017 available at [https://www.chronicle.com/article/if-republicans-get-their-way/241659?cid=wcontentlist\\_hp\\_latest](https://www.chronicle.com/article/if-republicans-get-their-way/241659?cid=wcontentlist_hp_latest); Andrew Kreighbaum, *House and Senate negotiators release final details of tax reform agreement expected to win approval*, Inside Higher Education, Dec. 18, 2017 available at [https://www.insidehighered.com/news/2017/12/18/large-endowments-would-be-taxed-under-final-gop-tax-plan#disqus\\_thread](https://www.insidehighered.com/news/2017/12/18/large-endowments-would-be-taxed-under-final-gop-tax-plan#disqus_thread).

<sup>113</sup> The tax threshold was increased to protect Hillsdale College, beloved by conservatives for its political views and refusal to accept federal assistance.

<sup>114</sup> The archetypal example is Berea College, which uses approximate 75% of its endowment spend rate for scholarships for students.

restricted funds are limited to scholarship assistance, and as Table 5 below indicates, the amount of unrestricted endowment assets is large enough to substantially increase scholarship assistance. This argument ignores that large sums are raised annually through new contributions, which are not subject to the tax.<sup>115</sup>

**Table 5**

**Allocation of Endowment Funds at Harvard, Princeton, and Yale (in thousands of dollars)**

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Harvard <sup>116</sup>	\$6,148,173	\$23,032,044	\$7,916,257	\$37,096,474
Princeton <sup>117</sup>	\$10,649,353	\$11,921,478	\$2,041,247	\$24,803,503
Yale <sup>118</sup>	\$4,573,133	\$20,251,572	\$3,901,251	\$28,986,158

Another concern was that donors would be reluctant to give to universities if their gifts were taxed. That does not seem very likely. When donations are placed in an endowment, and those funds then placed in alternative investments, they incur outside management fees far greater than the proposed excise tax. Concerns that taxing endowments would likely raise tuition costs and depress spending on research because of a mere 1.4% tax on investment income were far-fetched, save for a few small colleges.

Another common concern was the ‘camel’s nose under the tent’ conundrum, meaning that through taxing investment income, the government might control how endowment funds were spent, at the expense of institutional freedom. However you look at the proposed tax, the governmental camel has had its nose inside the higher education tent since the nineteenth century.<sup>119</sup> Currently, government controls partners through requirements concerning the use of

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<sup>115</sup> The amount of unrestricted funds will increase enormously when the “temporarily restricted” category is eliminated under FASB Accounting Standards Update 2016-14, *supra* note 12.

<sup>116</sup> [https://finance.harvard.edu/files/fad/files/final\\_harvard\\_university\\_financial\\_report\\_2017.pdf](https://finance.harvard.edu/files/fad/files/final_harvard_university_financial_report_2017.pdf) at p.16.

<sup>117</sup> <https://finance.princeton.edu/princeton-financial-overview/report-of-the-treasurer/index.xml> at p.23.

<sup>118</sup> <https://your.yale.edu/work-yale/finance-and-business-operations/accounting/financial-reports> at p. 54. Figures combine Donor restricted funds and board designated endowment.

<sup>119</sup> The relationship between govt. and universities began during the civil war. Government provided federal money and exemption from direct oversight in exchange for educational institutions providing a service to society. In 1862 the Morrill Act charged land grant colleges to promote the liberal and practical education of the industrial classes.

Introduction of tax exemption for public and private universities in the early 20<sup>th</sup> century formalized the

the immense amounts of federal research funds that go to private universities, as well as the mandates surrounding scholarship programs such as Pell grants, which aid students from poor families. Most of the arguments against the tax seem to assume that the endowments themselves would be taxed, when in fact the impact would be to reduce the results of investing. Though the other efforts to tax universities or their students were removed from the final legislation, the endowment tax arguments were ignored.

The net investment income tax does reduce funds available to an affected University. Harvard's president Drew Gilpin Faust estimated the cost would be \$43 million for the 2018-2019 fiscal year, and an estimate for Princeton with a ten percent gain on its net investment income is \$34 million.<sup>120</sup> These are not small sums, but in the context of the amount of investment income earned annually, they are merely a cost of doing business, more reasonable than the compensation owed to hedge funds and private equity firms. The tax will not cause a substantial impact on a school's endowment or programs.

### *An Attack on Higher Education*

Historically, support for higher education has been bipartisan in a political and economic class sense. However, there has been a recent fundamental shift in attitude towards the value of higher education. A survey conducted by the Pew Research Center in June 2017 found that there were widespread differences in opinion over the impact of educational institutions, particularly colleges and universities. While the majority of the public (55%) continue to express the view that colleges and universities have a positive effect on the way things are going in the country, Republicans express increasingly negative views over the impact of higher educational

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reciprocity. After World War II the Serviceman's Readjustment Act of 1944, more commonly known as the GI Bill, sent more than two million former soldiers to college, making higher education a broadly accessible avenue of social mobility. The Cold War expanded the government-university joint venture. In the 1980s, tuition began rising as administrators sought to replace declining state support. The elite universities, who resisted Congress's calls for lower tuition, seemed to ignore the enormous tax breaks they received. See, Emily J. Levine & Mitchell L. Stevens, *The Right Way to Fix Universities*, N.Y. Times, Dec. 1, 2017 at A27.

<sup>120</sup> See, John S. Rosenberg, *Endowments: The Specter of Taxation*, *Harv. Mag.* Nov. 6, 2017 available at <https://harvardmagazine.com/2017/11/taxing-university-endowments>; N. Gregory Mankiw, *Who Loses When Endowments are Taxed*, N.Y. Times, Dec. 24, 2017. A graduate of Princeton, N. Gregory Mankiw is the Robert M. Beren professor of economics at Harvard. He was Chairman of the Council of Economic Advisers from 2003 to 2005 in the administration of George W. Bush.

institutions.<sup>121</sup> Student protests at certain schools, which disrespected the ideals of free speech may have incensed many. This, combined with an image of an exasperating faculty that does not teach much, produces useless research, and is overwhelmingly liberal politically may be driving the shift in Republican opinion. The values of diversity and inclusion espoused and institutionalized in universities, has led to criticism of political correctness and a reaction against arrogant elites.<sup>122</sup>

Given these opinions, the endowment excise tax may not be based on the ostensible policy justifications of tuition relief and improving access for lower income individuals but instead on the factional rhetoric of current public discourse. The legislation reflects a recent hostility towards private higher education, which has become a partisan political issue.<sup>123</sup> The legislation has the effect of punishing institutions that happen to be considered ‘liberal’ and are overwhelmingly located in so-called “blue states.”

### *Ambiguities in the Legislation*

*The relationship between net investment income and “assets directly carrying out the institution’s exempt purposes”*

It is likely that the institutions affected by the new legislation will attempt to minimize the impact and size of the tax. There are a number of ambiguities in the new legislation that will

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<sup>121</sup> Pew Research Center, *Sharp Partisan Divisions in Views of National Institutions*, July 10, 2017, available at [http://www.people-press.org/2017/07/10/sharp-partisan-divisions-in-views-of-national-institutions/pp\\_17-06-30\\_institutions\\_media\\_churches\\_colleges/](http://www.people-press.org/2017/07/10/sharp-partisan-divisions-in-views-of-national-institutions/pp_17-06-30_institutions_media_churches_colleges/). A majority of Republicans and Republican-leaning independents (58%) now say that colleges and universities have a negative effect on the country, up from 45% last year. By contrast, most Democrats and Democratic leaners (72%) say colleges and universities have a positive effect, which is little changed from recent years. Over the past two years, the share of Republicans and Republican “leaners” who view the impact of colleges and universities positively has declined eighteen percentage points (from 54% to 36%), and this shift in opinion has occurred across most demographic and ideological groups within the GOP. *Id.*

<sup>122</sup> In the 2016 presidential election, Donald Trump took two-thirds of the non-college white vote. College graduates favored Hilary Clinton by a nine point margin. Trump won support of 52% of those without college degrees. See, *Jack Stripling, A Humbling of Higher Ed*, Chron. Higher Ed. Nov. 11, 2016 available at <https://www.chronicle.com/article/A-Humbling-of-Higher-Ed/238378>

<sup>123</sup> Over the past two years, the share of Republicans and Republican “leaners” who view the impact of colleges and universities positively has declined eighteen percentage points (from 54% to 36%), and this shift in opinion has occurred across most demographic and ideological groups within the GOP. Since 2015, positive views of colleges and universities have fallen 11 points among Republicans with a college degree or more education (from 44% to 33%) and 20 points among those who do not have a college degree (57% to 37%). There also have been double-digit declines in the share of conservative Republicans (from 48% to 29%) and moderate and liberal Republicans (from 62% to 50%) who say colleges have a positive effect on the country. By 2016, Republicans’ ratings of colleges and universities were mixed (43% positive, 45% negative). *Id.*

need to be addressed through treasury regulations. Net investment income (NII) is a number that appears on a balance sheet; it is a picture of an organization on the last the last day of its fiscal year. Income from investments flows to the institution throughout the fiscal year, so the net investment income appears on the income statement reflecting the profit and losses.

There is an exception in the calculation of endowment assets per student formula for “assets used directly in carrying out the institutions exempt purposes.” It is uncertain what this phrase includes. Some university officials have claimed all of a school’s assets are used in furtherance of the institution’s “exempt purposes.”<sup>124</sup> That argument is unpersuasive. What if the institution decides to build a new dormitory, research laboratory, or some other building that will be used directly “in carrying out the institutions exempt purposes”? Could the board of trustees obtain financing for the project with the promise of designating all of the net investment income for a certain period to pay for the project? The NII would be restricted in advance. Would such capital projects enable a college or university to avoid the excise tax for the amount of the undertaking? Presumably, the Treasury Regulations will address this situation.

#### *Manipulating Net Investment Income*

Annual net investment income is a principal element of the bragging rights in the annual endowment performance derby. It is particularly important for those who work in endowment offices because a large part of their compensation is based upon their ability to achieve return on investment. Frequently, the best performers exceed the institution’s president in compensation.<sup>125</sup>

Endowments will likely manage their net investment income to minimize the excise tax in ways similar to what individual and corporate investors do to reduce their tax burdens. They will time investment gains and harvest losses so as to minimize taxation. In down markets, net

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<sup>124</sup> Stephen Briggs, president of Berry College in Georgia, which expects to pay the tax in the near future, stated “We would argue that there's nothing that we generate that's not used to carry out the institution's educational purposes,” See, Richard Rubin and Andrea Fuller, *Small Colleges Take Big Hit From Tax Law*, Wall St. J. Jan. 19, 2018 at A1.

<sup>125</sup> Sometimes compensation is outsized even when performance is mediocre. In 2016, the Harvard Management Company’s top seven endowment staff received a combined \$50.9 million. The former head of real estate, received \$23.8 million, making him the highest paid employee at the endowment in a period when the fund trailed peers. The endowment gained 8.1 percent in the year through June 30, trailing the average 12.2 percent return for about 800 funds. Drew Faust, Harvard’s president in 2016 received a pay package of \$1.5 million, which included about \$600,000 in deferred compensation and benefits such as housing. Michael McDonald, *Harvard Paid Ex-Head of Real Estate \$23.8 Million in 2016*, Bloomberg, (May 11, 2018) available at <https://www.bloomberg.com/news/articles/2018-05-11/harvard-paid-former-head-of-real-estate-23-8-million-in-2016>. Because of ongoing mediocre results, Harvard has outsourced more investment responsibility changed its compensation approach. Harvard Financial Report, *supra* note 48 at 8.

investment income is reduced. In bull markets, returns generally are higher. Returns depend in part on market volatility. For example, over the ten-year period from 2007 to 2017 of U.S. college and university endowments in the NACUBO-Commonfund surveys, there were wide swings in endowment performances. In three of the ten years, average annual net returns were negative: -3% in 2008, -18.7% in 2009, and -1.9% in 2016.<sup>126</sup> The other years' returns were positive ranging from 2.4% in 2015 to 19.2% in 2011.<sup>127</sup> Manipulating NII may encourage smoothing out returns through more liquid investments and other efforts to lower the excise tax. I.R.S. Notice 2018-55 enables endowments to use the fair market value as of the end of 2017 as the basis for determining investment income.<sup>128</sup> This should reduce investment income in the first few years that the excise tax will be imposed in comparison to a scenario where the actual purchase price of the investment was the basis.

#### *Adding Students to Evade the Assets/Student Trigger*

Institutions that accept more applicants and thereby reduce the endowment assets per student ratio may avoid the excise tax, but there are additional marginal costs to increasing student body, including the need for more housing, support services, and sections for large enrollment courses. The statute as enacted seems to ignore all of these factors. Such a strategy likely will only postpone the tax trigger as the endowments will continue to grow and may outpace student growth.

Philip B. Levine, an economics professor at Wellesley has forecast endowment values for future years depending on the speed at which endowments grow. He predicts between forty-one to sixty-one educational institutions will be subject to the tax in ten years, and fifty-five to eighty in fifteen years.<sup>129</sup>

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<sup>126</sup>Rick Seltzer, *Endowments Rebound, but Is It Enough*, Inside Higher Ed, Jan. 25, 2018 citing Fiscal Years 2016-2017 NACUBO-Commonfund Study of Endowments, available at Rick Seltzer, *Endowments Rebound, but Is It Enough*, Inside Higher Ed, Jan. 25, 2018 citing Fiscal Years 2016-2017 NACUBO-Commonfund Study of Endowments, available at <https://www.insidehighered.com/news/2018/01/25/college-endowments-rise-122-percent-2017-experts-worry-about-long-term-trends>.

<sup>134</sup> *Id.*

<sup>128</sup> *See, supra* note 9.

<sup>129</sup> Professor Levine's figures are dependent on student growth, stock market volatility, endowment spending rates, and the impact of the increase in the standard deduction, which may impact contributions from less affluent alumni donors, *See, Seltzer, number of institutions subject to the newly enacted tax could grow by dozens in future years, supra*, note 7. Lower estimates reflect a growth rate of 4%; the higher estimate assumes a growth rate of 8 percent.

### *Reducing the Number of Tuition Paying Students*

The legislation only applies to institutions with at least “500 tuition-paying students”, the so-called Berea College exception.<sup>130</sup> Assume a college has a one-billion-dollar endowment and six hundred students. Could the institution rearrange its financial aid packages, so that it gives 101 grants in aid as full tuition scholarships, and all other aid to students in the form of loans? This would bring the institution below the trigger for the tax. It does not seem to be an effective way of managing financial aid, but it could be cost efficient. Or, could the institution or its alumni create an independent nonprofit corporation, not under the college’s control, to raise money for financial aid and give either full-tuition scholarships or partial assistance to those students receiving loans from the college? It is likely and justified that institutions may try to game the legislation’s criteria for application.

## **IV. Flaws of a Political and Punitive Statute**

### *Lack of Public Policy Incentives*

Even if there are justifications for an excise tax on endowment investment income, such as reducing the tuition burdens on middle class families and increasing diversity, the legislation ignores them. There are no incentives for endowments to implement any changes. The endowment tax makes such initiatives more unlikely.

The tax is a transfer to the federal government of funds that could and should be used to support reductions in tuition, making education more accessible and affordable. The estimated revenue raised will be only \$1.8 billion over 10 years, a proverbial drop in the bucket. To transfer the money to the federal treasury to reduce the deficit, estimated at \$1.5 trillion, is a travesty.

### *The Legislation is Over-inclusive and Under-inclusive*

#### *The Five Percent Solution: Should There Have Been Mandatory Spend Rates?*

Congressional focus was to get the large endowments to spend more to reduce tuition.

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<sup>130</sup> See, *supra*, note 1 and *infra*, at p.32.



Senator Grassley and others suggested that endowments be subject to mandatory minimum spending rates of five percent of assets, the same as required of private foundations.<sup>131</sup>

Numerous others in Congress criticized tuition increases far above the rate of inflation, yet the statute made no demands nor gave incentives to spend more or to reduce tuition. Should a mandatory spend rate have been included in the legislation to force a tuition reduction? Large endowment institutions may be more likely to offer larger amounts of financial aid and to have modest tuition increases over time.<sup>132</sup> A payout requirement applied to all institutions regardless of endowment size could impose a greater burden on institutions with smaller endowments.<sup>133</sup>

In 1969 private foundations were required to make distribution payouts because of the concern that many were created to avoid taxes and protect control of businesses and a belief that their resources entered the charitable stream more slowly than public charities.<sup>134</sup> Private foundations usually are established to assist others, whereas endowments are instruments to assist a university achieve its mission in the way its board deems most suitable.<sup>135</sup>

Another difference is the nature of most endowment investing. Typically, the larger endowments' returns are more volatile than those of private foundations. Endowment portfolios contain riskier investments in their pursuit of greater rewards. Foundation investing strategy is limited by the prohibition against jeopardy investments.<sup>136</sup> Examining the ten year trailing

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<sup>131</sup> *College and University Endowments: Overview and Tax Policy Options*, supra note 32, at 16-17. Janet Lorin & Loren Streib, *House Panel Questions College Endowment Spending, Tax Benefits*, Oct. 7, 2015, available at <https://www.bloomberg.com/news/articles/2015-10-07/house-panel-questions-college-endowment-spending-tax-benefits>. See, I.R.C. § 4942. Private foundations must make annual qualifying distributions in an amount equal to five percent of the fair market value of their net investment assets. Qualifying distributions include grants for charitable purposes, reasonable administrative costs related to the grant making process, payments to acquire assets used in the conduct of the foundation's exempt activities, and expenses of conducting direct charitable activities.

<sup>132</sup> See, Alexander M. Wolf, *The Problems with Payouts: Assessing the Proposal for a Mandatory Distribution Requirement for University Endowments*, 48 Harv. J. on Legis. 591, 607 (2011).

<sup>133</sup> *Id.* at 606, 615.

<sup>134</sup> The same concern today has been voiced over donor advised funds where the donor obtains the full charitable deduction immediately, but there is no requirement that the fund distribute any of its assets with a certain period of time. See, James Andreoni, *The Benefits and Costs of Donor Advised Funds*, 32 Tax Policy and the Economy, Number 1, (2018), Ray D. Madoff, *It's Time to Reform Donor-Advised Funds*, 69 Exempt Org. Tax Rev. 77 (2012).

<sup>135</sup> The comparison for spending requirements should not be to the private foundation, but to a sibling structure, the private operating foundation, which is a private foundation that spends at least 85 percent of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of its exempt activities. These foundations generally are still subject to the tax on net investment income and to the other requirements and restrictions that generally apply to private foundation activity. However, operating foundations are not subject to the excise tax on failure to distribute income.

<sup>136</sup> See, I.R.C. § 4944, which subjects private foundations to an excise tax of ten percent if it invests in a manner that jeopardizes its carrying out of its exempt purposes.

returns of the billion dollar endowments, one finds there are lean years along with plentiful ones. It is the fiduciary responsibility of an endowment's board or the university trustees to determine the appropriate spend rate, which is often in a band or collar. For example, Princeton's spend rate was 5% in fiscal 2016-2017, but it could be between 4 to 6.25%.<sup>137</sup> The spending range depends upon the return of the endowment's investments and the needs of the institution.

A factor working against a fixed minimum distribution is inertia. The private foundation distribution range is a minimum requirement, and there is a reward if a foundation distributes more than the minimum. Its tax rate on investment income will be lower.<sup>138</sup> Yet, many private foundation trustees treat the 5% requirement as a mandate with no thought given to increasing the distribution rate to lower the investment income tax.<sup>139</sup>

### *Reducing Tuition*

Tuition is a major revenue source based on the costs of providing the education and cannot be reduced save for lower costs or deflation. What critics really should have demanded, particularly at the large endowment institutions, was an increase in the discount rate, i.e. the amount of the financial aid package that the institution provides, which is deducted from the published tuition and perhaps room and board rates. Particularly at the elite schools, there is a significant cohort of parents and students who can and should pay the sticker price.

Many elite schools have taken steps to reduce the costs for middle and low-income families by increasing the family income eligibility for financial aid.<sup>140</sup> They have also eliminated or reduced the loan component of the aid package.<sup>141</sup> Where the large endowment schools have fallen down is they have not increased the size of their student bodies by much or

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<sup>137</sup> Princeton University, Report of the Treasurer 2016-2017 16 (2017).

<sup>138</sup> I.R.C. § 4940. The tax rate can be reduced from 2 to 1%.

<sup>139</sup> Akash Deep and Peter Frumkin found that the level of distributions from foundations clustered around five percent and there was little consideration by program officers about whether a higher level might be appropriate. See, *The Foundation Payout Puzzle*, Hauser Center for Nonprofit Organizations, Working Paper 9 (2005), available at <http://ssrn.com/abstract=01826>.

<sup>140</sup> Melissa Korn, *Princeton, Others Aim to Accept More Low-Income Students*, Wall St. J. March 1, 2018, available at <https://www.wsj.com/articles/princeton-others-aim-to-accept-more-low-income-students-1519900203>.

<sup>141</sup> At Harvard, parents of students earning less than \$65,000 pay nothing for their children's education. Parents who earn between \$65,000 and \$150,000 are expected to contribute 0-10% of their income. Sixty percent of the undergraduate student body pays \$12,000 on average per year. See, <https://college.harvard.edu/financial-aid/how-aid-works>. Anne Marie Chaker, *Some Colleges Cut, Eliminate Student Debt --- Soaring Tuition, Pressure To Spend Endowments Spur Schools to Offer More Grants*, Wall St. J., Nov. 29, 2007 available at <https://www.wsj.com/articles/SB119630622387507526>

the percentage of underrepresented constituencies.<sup>142</sup> Congress never understood the tuition issue, and the statute ignores it.

*An Assets per Student Ratio is Irrelevant and Arbitrary*

The legislation as enacted is both over and under-inclusive. It is over-inclusive as it assumes that all billion-dollar endowments with assets of at least \$500,000 per student are the same. Private schools differ greatly even if their assets per student are similar. Mark S. Wrighton, Chancellor of Washington University in St. Louis, an institution bumping up against the excise tax eligibility with an endowment of \$454,729/student, criticized the endowment tax proposal for singling out a set of universities based on an arbitrary set of criteria:

“The number of enrolled students, size of the endowment and private nonprofit university status have absolutely nothing to do with the quality of an institution’s education offerings and research, its efficiency in operations or other services provided.”<sup>143</sup>

Some affected schools may have a healthy endowment but a decaying physical plant or student recruitment problems. Schools may have very different capacities for fundraising and investment prowess. Schools subject to the tax have differing marginal costs of educating students. A predominantly undergraduate college that educates most students in the liberal arts, may have lower marginal costs than a university with several professional schools that focus on innovative research, requiring expensive laboratories and equipment. Graduate education generally requires more small classes and one-to-one teaching. Faculty engaged in STEM research: Science, Technology, Engineering and Mathematics, including chemistry, computer and information technology science, engineering, geosciences, life sciences, mathematical sciences, physics, and astronomy may cost their institutions more than faculty research in the arts, law or business.

Initially, an unintended casualty of the excise tax was Berea College, a Kentucky school that only admits students whose families cannot pay for a degree. Ninety-eight percent of the students receive federal Pell grants, 64% are first generation college students, and the median

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<sup>142</sup> Schlunk, *Why the Charitable Deduction for Gifts to Educational Endowments Should Be Repealed*, *supra* note 68, at 736-737.

<sup>143</sup> Letter to Senator Roy D. Blunt, Nov. 5, 2017 available at <https://source.wustl.edu/wp-content/uploads/2017/11/The-Honorable-Roy-D.-Blunt.pdf>.

income of students' families is \$29,000. Berea's \$1.150 billion endowment averages \$692,571 per student.<sup>144</sup>

The purported goal of the endowment excise tax was to prod universities such as Harvard and Yale to channel more of their endowments into financial aid and lower tuition. Berea is unusual in that it uses the large endowment to provide free tuition to its students, many of whom are low-income, and also work on campus. Its historical mission is to help students from Appalachia and beyond, many of whom could not otherwise afford higher education. Berea fulfills the rhetorical justifications of the act and its supporters. It was principally included and later exempted because of politics.<sup>145</sup> One of its senators, Mitch McConnell (R-Ky.), is the majority leader.<sup>146</sup>

Smaller enrollment schools such as liberal arts colleges with large endowments and few students are disproportionately affected by the tax, making it more difficult for them to achieve the purported rationales of reducing tuition and increasing the number of low-income students. An example is Cooper Union of the Arts and Sciences, a venerable institution with an endowment of \$700 million and a student body just shy of 1,000 that had no tuition for over one hundred years until a financial crisis brought on by board mismanagement forced the imposition of a half tuition charge in 2014. In a settlement with the New York Attorney General, who entered a dispute between the Committee to Save Cooper Union, an alliance of students, faculty and alumni opposed

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<sup>144</sup> Correspondence from Timothy W. Jordan, Berea College. The School funded 75.4% of its budget in 2017 from the endowment and provides four-year scholarships for its students at a per value student of \$38,000. All students commit to working on campus during their educational careers, which covers the \$3000 difference between the \$35,000 paid by the endowment and tuition's true cost. Clearly, the endowment excise tax meant fewer students would have received aid.

<sup>145</sup> Senator McConnell's efforts to create an exception for a Kentucky educational institution initially failed, objected to by Senator Bernie Sanders of all people, as a carve out for a senator's home state. The Senate parliamentarian agreed that language creating an exception violated Senate budget rules that prohibit "extraneous" matters and policymaking or bills that use a special procedure to avoid filibusters. The Bipartisan Budget Act of February 2018 gave a bespoke exemption to Berea. It added the words *tuition paying* to I.R.C. § 4968, so that any college with fewer than 500 "*tuition-paying*" students and an endowment per student ration of \$500,000 would avoid the endowment excise tax. It is likely the words *tuition-paying* will become subject to detailed treasury regulations. As all of Berea's 1,661 students attend for free, it avoided the tax. What if Berea's venue was not in Kentucky? Professor Zelinski disagrees with the Berea exemption, which was granted in Senator McConnell's words "for doing good things with its endowment." Professor Zelinski responds all taxpayers do good things with their money. Berea uses public services just like the university endowments, which are taxed, and it has the financial capacity to pay the net income tax. Zelinski, *supra* note 70 at 54

<sup>146</sup> *Id.*

to the administration, the trustees agreed to attempt a return to the free tuition policy. The excise tax makes that goal more difficult.<sup>147</sup>

Unlike the biggest endowments and even some smaller ones, Cooper Union's endowment is due to a single individual and extraordinary luck. Its founder Peter Cooper donated farmland to the school on which the iconic Chrysler building in Manhattan now stands. The college receives an annual fee for the ground rent. The potential for excessive accumulation is non-existent: there is no core of extremely wealthy alumni, foundations or others that will support the school.

Smaller schools with a billion-dollar endowment face a Hobbesian choice as they approach the 500 student excise tax trigger. What should a school do if it fears that admitting an extra student or two or its yield rate one year is higher than expected will push it over the assets/student trigger? Are the triggering students worth \$600,000 in possible taxes? While some schools might want to increase enrollment as they hit the \$500,000 per student threshold, that may bring other costs: can they house the additional students? Will they have to hire new faculty or create new sections to teach them?<sup>148</sup>

#### *Exemptions from the Tax of Certain Large Endowment Schools*

The statute is under-inclusive in that some huge endowments are exempt because they have a large student population. Among the schools that are exempt from the excise tax and their endowments are: Columbia (\$9.996 billion) Cornell (\$8.6 billion), Duke (\$7.9 billion), Johns Hopkins (\$3.8 billion), N.Y.U. (\$3.99 billion), Northwestern (\$10.4 billion), Penn (\$12.2 billion), and University of Southern California (\$5.1 billion). The Wall Street Journal found that, based on figures from 2013, fourteen private schools with endowments of \$2 billion or more were exempt from the tax on investment income because they had enough students to avoid the \$500,000 trigger.<sup>149</sup>

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<sup>147</sup> See, Charles V. Bagli, *State Reaches a Deal to End Litigation at Cooper Union*, N.Y. Times, Sept. 2, 2015 at A19, available at <https://www.nytimes.com/2015/09/02/nyregion/new-york-attorney-general-crafts-deal-to-end-litigation-at-cooper-union.html>.

<sup>148</sup> Hamilton College, in Clinton, New York, where the endowment recently reached \$1 billion, is likely to just surpass the per-student threshold, which will trigger a \$500,000 tax bill, out of a \$180 million annual budget. Expanding Hamilton's 1,865 student enrollment might defer the tax. In the words of Karen Leach, Hamilton's vice president for administration and finance: "The most logical thing is to look at enrollment, But there's other things to consider. I don't have any housing to put them in." See, Rubin & Fuller, *supra* note 96.

<sup>149</sup> *Id.*

No matter what the number of students, universities with multi-billion-dollar endowments have substantial advantages over others with fewer resources. If there is to be a tax based on the investment income of certain sized endowments, no endowments should be exempt on the basis of the asset per student ratio.<sup>150</sup>

### *A Need to Repeal or Substantially Amend the Existing Legislation*

The investment income tax as presently structured is clearly a punitive tax that treats similarly situated school endowments differently and different types of endowments the same.

There is no logic behind the \$500,000 assets per student, which does not reflect whether an institution's endowment accumulation is excessive or not. Schools' marginal cost of education differ, and endowments play varying roles in the attainment of educational missions. Size alone may not be the most significant vehicle. The legislation recognizes none of this.

Already introduced is bipartisan legislation to repeal the endowment investment income tax. The "Don't Tax Higher Education Act" is sponsored by representatives John Delaney (D-Md.) and Bradley Byrne (R-Ala.).<sup>151</sup> It is unlikely to pass in the current Congress.

## **V. Existing Legislation Aside: Should Net Investment Income Be Subject to Tax?**

Discounting the political focus of the current legislation, are there reasonable arguments for an excise tax on investment income? From a legal, tax, and public policy point of view, there are. If the investment income tax is applied more fairly and will raise funds for public policies that promote important societal goals of reducing inequality and improving access to elite educational opportunities, there are justifications to use tax legislation that will encourage such specified initiatives.

### *State and Local Erosion of Tax Exempt Status*

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<sup>150</sup> Professor Zelinski proposes a single tax rate or single rate schedule should apply to the net investment incomes of all charitable endowments. See, Zelinsky, *supra* note 91 at 63.

<sup>151</sup> Adam Harris, *A Tax on Endowments Became Law. But Congressmen and Colleges Are Still Fighting It*, Chron. Higher Ed., March 8, 2018 available at [https://www.chronicle.com/article/A-Tax-on-Endowments-Became/242774?cid=at&utm\\_source=at&utm\\_medium=en&elqTrackId=b402a8281ec947d3a7baef7e7d3edc1c&elq=60bc1ad427684531b2a849a79770a462&elqaid=18127&elqat=1&elqCampaignId=8075](https://www.chronicle.com/article/A-Tax-on-Endowments-Became/242774?cid=at&utm_source=at&utm_medium=en&elqTrackId=b402a8281ec947d3a7baef7e7d3edc1c&elq=60bc1ad427684531b2a849a79770a462&elqaid=18127&elqat=1&elqCampaignId=8075).

Despite their tax-exempt status, colleges and universities in many states are already paying the equivalent of taxes to local municipalities. Financially pressed localities have implemented so-called “pilots”, payments in lieu of taxation, whereby nonprofits make payments for the services they use in lieu of taxation. Such payments are a matter of voluntary agreement reached between the municipality and the nonprofit. Harvard, Yale and Princeton make such payments.<sup>152</sup> At the state level, Massachusetts and Connecticut introduced bills to tax large endowment educational institutions. Massachusetts would have imposed a 2.5% tax on endowments in excess of \$1 billion, which would have affected several of the state’s colleges and universities. Connecticut targeted only Yale.<sup>153</sup> Both bills were defeated.<sup>154</sup>

### *A Growing Inequality*

The sharp contrast between the resources of endowment-rich educational institutions and the rest of higher education reflects the growing inequality within the United States. A 2016 study by economists Thomas Piketty, Emmanuel Saez & Gabriel Zucman shows the increasing wealth of the upper one percent of pre-tax income compared to the stagnation of the bottom fifty percent.<sup>155</sup> The endowment elite of colleges and universities mirror their results. Their growing

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<sup>152</sup> Adam H. Langley, Daphne A. Kenyon, and Patricia C. Bailin, *Payments in Lieu of Taxes by Nonprofits*, Lincoln Institute of Land Policy, Sept. 2012, available at <https://www.lincolnst.edu/publications/working-papers/payments-lieu-taxes-nonprofits>. (“PILOTs have been received by at least 218 localities in at least 28 states since 2000; these payments are collectively worth more than \$92 million per year. Although more than 90 percent of all PILOT revenue comes from “eds and meds”—college payments are far more important than hospital payments with colleges contributing about two-thirds of PILOT payments and hospitals another quarter.”)

<sup>153</sup> *Id.*

<sup>154</sup> Schlunk, *supra* note 68, at 702 n.2. Connecticut’s bill would tax only endowments with over \$10 billion in assets i.e. Yale. Though the measure was eventually defeated, Florida Governor Rick Scott invited Yale to move to the Sunshine State and promised that it would not raise taxes on its endowment. Yale graciously declined. *See, As Conn. Mulls Endowment Tax, Fla. Invites Yale to Relocate*, Chron. Philanthropy, Apr. 5, 2016, available at [https://philanthropy.com/article/As-Conn-Mulls-Endowment-Tax/235975?cid=pt&utm\\_source=pt&utm\\_medium=en&elqTrackId=5af58cf0a35848fd9148e75ff89b31c8&elq=1acdafca5b504a139a9a4d4adbe37d4c&elqaid=8547&elqat=1&elqCampaignId=2835](https://philanthropy.com/article/As-Conn-Mulls-Endowment-Tax/235975?cid=pt&utm_source=pt&utm_medium=en&elqTrackId=5af58cf0a35848fd9148e75ff89b31c8&elq=1acdafca5b504a139a9a4d4adbe37d4c&elqaid=8547&elqat=1&elqCampaignId=2835).

<sup>155</sup> *See*, Thomas Piketty, Emmanuel Saez & Gabriel Zucman, *Distributional National Accounts: Methods and Estimates for the United States*, Working Paper 2016-12, Washington Center for Equitable Growth, Dec. 6, 2016, available at <http://equitablegrowth.org/working-papers/distributional-national-accounts/>. Their study found the average pretax earnings of an American in the bottom 50 percent by income was \$16,197 in 2014, a nearly invisible 2.6 percent gain over 40 years. However, over the same period, the top 10 percent of Americans saw their pretax incomes grow by 231 percent. Government spending has helped lift lower incomes, but only by a small amount. The top 1% and the bottom 50% have swapped their relative shares of the national income. Forty years ago, the top 1 percent of earners took home 10.5 percent of the total national income, and the bottom half earned 20 percent of it. By 2014, those percentages effectively flipped, with the top 1 percent earning a 20 percent share and the bottom half dropping to 12.5 percent.

resources compared to their less wealthy educational brethren reinforce a class system that furthers inequality and lack of opportunity. Those at the top rung of income distribution seek and succeed to matriculate at the most prestigious colleges and universities, which perpetuates inequality for those at lower economic rungs.

Large endowment schools have a competitive advantage in recruiting students through scholarships and tuition discounts, and faculty through higher salaries, perquisites, and bigger and better research facilities. The growing inequality of endowment wealth puts less endowed institutions at a competitive disadvantage, leading to a greater concentration of human capital and resources in a very few institutions.<sup>156</sup> The concentration of wealth in the largest educational endowments is staggering.

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Between the end of World War II and the 1980s, the gap between effective tax rates on the rich and the poor narrowed as a result of reductions in corporate and estate taxes on the upper class and increases in payroll taxes on the working class. In 2013, the Obama administration sharply reversed the trend of declining top tax rates by allowing the 2001 Bush tax cuts to expire and introducing new surtaxes to fund the Affordable Care Act. The Trump administration and the Tax Reform and Jobs Creation Act of 2017 has reversed the post 2013 trends in favor of the wealthiest 1%.

Since the 1960s, more American women have joined the work force and their pay has increased, counteracting measures of rising inequality. In 1964, women made up only 38 percent of the work force; they are now nearly half of it. Despite these gains, as you look farther up the income ladder, you find fewer and fewer women. Women are 48 percent of the American work force, but only one in 10 of the top 0.1 percent of earners.

Even for the upper-middle-class group, which the authors define as adults with incomes between the bottom half and the top 10 percent of Americans, pretax incomes haven't grown over the past 15 years. Only rising public spending on benefits like health care has allowed upper-middle-class incomes to grow.

<sup>156</sup> Jonathan R. Cole, former provost at Columbia, points out the problem of endowment inequality: "Up to some point...levels of inequality and the concentration of resources can transform very good institutions into great ones. Beyond a certain point, however, there can be too much of a good thing—a level of inequality that becomes unhealthy for the larger system of higher learning. *The Great American University* 474-476 (2009).



**Table 6**  
**PORTRAITS OF CONCENTRATION**

**Harvard and Yale's combined endowments of \$63.197 Billion = 11.15% of all 809 endowments in the 2017 NACUBO-Commonfund Endowment Survey.<sup>157</sup>**

**Harvard and Yale's combined endowments as a percentage of the endowments of the top ten schools in endowment assets = 32.1%<sup>158</sup>**

**The top five schools' combined endowment assets as a percentage of the endowments of the 809 Institutions = 24.4%<sup>159</sup>**

**The top ten schools' in combined endowments as a percentage of the endowments of the 809 Institutions = 34.7%<sup>160</sup>**

A public policy justification for a tax on endowment investment income and an increase of spend rate is that it will slow the accumulation of endowment assets beyond an optimal size. There is a bias among institutional constituencies favoring accumulation to assure intergenerational equity and equality.<sup>161</sup> Complementing the enormous wealth and the substantial amount of funds released by the average spend rate of billion-dollar endowments of 4.8% of assets is the increase in the number and amount of large gifts donated by philanthropists to a few universities. Many of these contributors were alumni of the recipients of their largess.<sup>162</sup> These institutions are prodigious fundraisers that provide current funds and other sources of

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<sup>157</sup> Harvard and Yale's Combined Endowments = \$36.02 Billion<sup>157</sup> + \$27.176 Billion = \$63.197 Billion. Total Endowment Value of 809 Schools = \$566.8 Billion. Harvard's 2017 Financial Report states the endowment amount as \$37.1 Billion. To maintain consistency with the NACUBO-Commonfund Endowment Report I have used the NACUBO-Commonfund figure of \$36.02 Billion. All figures are from the 2017 NACUBO-Commonfund Endowment Report.

Harvard and Yale's Combined Endowments/Total Endowment Value of 809 Schools = \$63.197 Billion/\$566.8 Billion = 11.15%.

<sup>158</sup> Harvard and Yale's Combined Endowments/Total Endowment Value of the Top Ten Schools' Endowments \$63.197 Billion/\$196,851,563 Billion = 32.1%.

<sup>159</sup> Top 5 endowments combined = \$138,329,895 Billion/\$566.8 Billion = 24.4% of all endowments.

<sup>160</sup> Top 10 endowments combined = \$196,851,563 Billion/\$566.8 Billion = 34.7% of all endowments.

<sup>161</sup> Halperin, *Tax Policy and Endowments—Is Excessive Accumulation Subsidized*, *supra* note 67 at 21.

<sup>162</sup> Charles T. Clotfelter, *How Rich Universities Get Richer*, Chron. Higher Educ. Rev. Oct. 27, 2017 available at <https://www.chronicle.com/article/How-Rich-Universities-Get/241567>.

increases to their endowments.<sup>163</sup> They have raised jaw-dropping sums through recent capital campaigns: Yale raised \$3.9 billion, Stanford \$6.2 billion, and Harvard's \$6.5 billion campaign raised \$8 billion.

The growing inequality in educational access even at schools with bulging endowments is demonstrated by the exhaustive research on intergenerational mobility by Raj Chetty, John N. Friedman, Emmanuel Saez, Nicholas Turner and Danny Yagan, who characterized intergenerational income mobility at each college in the United States using data for over 30 million college students from 1999-2013.<sup>164</sup> Among their findings was children whose parents are in the top 1% of the income distribution are 77 times more likely to attend an Ivy League college than those whose parents are in the bottom income quintile.<sup>165</sup> Among "Ivy-Plus" colleges (the eight Ivy League colleges, plus the University of Chicago, Stanford, MIT, and Duke), more students come from families in the top 1% of the income distribution (14.5%) than the bottom half of the income distribution (13.5%).<sup>166</sup> Only 3.8% of students come from the bottom quintile of the income distribution at Ivy-Plus colleges.<sup>167</sup>

The importance of attending elite schools was shown by the fact that children from low and high-income families have similar earnings outcomes conditional on the college they attend, indicating that low-income students are not mismatched at selective colleges.<sup>168</sup> Furthermore, the rates of upper-tail (bottom quintile to top 1%) mobility are highest at elite colleges, such as Ivy League universities, but the fraction of students from low-income families at elite private educational institutions did not change substantially between 2000 and 2011.<sup>169</sup> Even at the Ivy-Plus colleges, which enacted substantial tuition reductions and other outreach policies during this period, the fraction of students from lower quintiles of the parent income distribution did not

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<sup>163</sup> See, Michael McDonald, Janet Lorin, and Ivan Levingston, *Harvard Billionaires Bail Out Alma Mater From Poor Fund Returns*, Bloomberg, June 26, 2018, available at <https://www.bloomberg.com/news/articles/2018-06-26/harvard-billionaires-bail-out-alma-mater-from-poor-fund-returns>.

<sup>164</sup> Mobility Report Cards: The Role of Colleges in Intergenerational Mobility, (HCEO Working Paper Series 2017-059; (July 2017) available at [http://humcap.uchicago.edu/RePEc/hka/wpaper/Chetty\\_Friedman\\_Saez\\_etal\\_2017\\_mobility-report-cards.pdf](http://humcap.uchicago.edu/RePEc/hka/wpaper/Chetty_Friedman_Saez_etal_2017_mobility-report-cards.pdf).

<sup>165</sup> *Id.* at 3,14.]

<sup>166</sup> *Id.*

<sup>167</sup> *Id.* at 14.

<sup>168</sup> *Id.* at 4,21.

<sup>169</sup> *Id.* at 6

increase significantly.<sup>170</sup> These figures bolster an argument that elite schools' endowments should be used more for current spending to alleviate this lack of access for poorer constituencies in our society.

### *Justifications for an Investment Income Tax*

For Professor Halperin, the appropriate tax treatment of a charity's investment income turns on whether current law can be viewed as encouraging excessive accumulation and relatively more current spending by charities.<sup>171</sup> He believes there is a bias among administrators and endowment managers to accumulate, rather than to spend, and this does not reflect the interests of the institution, let alone society at large.<sup>172</sup>

Professor Zelinsky argues for an investment income tax for all educational entities, large and small, on the basis of analogy to similar institutions that are taxed such as corporations and private foundations.<sup>173</sup> Traditional tax policy criteria: the ability to pay, benefits received, economic neutrality, equity, revenue generation, and administrability justify, he believes, broad based taxation since all endowments utilize public services and have the capacity to pay the tax.<sup>174</sup> Carrying this theory further would undermine the justifications for any tax exemptions. The capacity to tax does not mean the tax should be imposed. The impact on smaller educational endowments would be severe, for unlike their wealthier brethren, small endowment institutions are less likely to have similar capacities for fundraising, increasing tuition, or garnering research grants.

There is justification for a more encompassing endowment investment income tax, if it could be offset, provided the institution serves the legislature's enunciated public policy goals of lessening inequality through increasing access and scholarship assistance to deserving students.<sup>175</sup> On these suppositions one could argue that the investment income tax should be imposed on all endowments, though the concerns raised are with excessive accumulation for the

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<sup>170</sup> *Id.* at 36-37.

<sup>171</sup> Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, *supra* note 67 at 310.

<sup>172</sup> *Id.*

<sup>173</sup> Zelinsky, *supra* note 90, at 166-170.

<sup>174</sup> *Id.* at 169-170.

<sup>175</sup> Note that Harvard spends but 3% or \$178 million of its \$5.9 billion operating budget on financial aid for undergraduate and graduate students.

future by the largest endowments. The need for more spending to provide financial assistance for underrepresented constituencies is now.

## **VI. Proposals for Change**

### *Taxing All Billion Dollar Endowments*

In place of the existing legislation, a net investment income tax should be imposed on all billion-dollar endowments that earn net investment income of over \$75 million or more in one fiscal year. For an endowment with assets of \$1 billion, this would impact upon those whose annual investment income increase is 7.5%. The size of the school's student body would be irrelevant. Only the size of the endowment and its investment income would determine a tax. The institution would have the option, should it desire, to reduce the amount of the tax though the proposals discussed below.

The current legislation only applies to private universities. There are arguments on both sides as to whether the tax should be extended to public educational institutions' endowment investment income.<sup>176</sup> In recent decades public universities have had their state support restricted to the extent that many can no longer compete with elite private schools.<sup>177</sup> It may

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<sup>176</sup> Under Supreme Court precedence a federal tax on the net investment income of state and local educational endowments avoids Tenth Amendment difficulties. *South Carolina v. Baker*, 485 U.S. 523 (1988). The issue in that case was whether removal of a federal tax exemption for interest earned on publicly offered long-term bonds issued by states or local governments unless the bonds were issued in registered as opposed to bearer form violated the Tenth Amendment and constitutional principles of federalism by compelling States to issue bonds in registered form or violated the doctrine of intergovernmental tax immunity by taxing the interest earned on unregistered state bonds. The registration requirement would help prevent tax evasion, because bearer bonds often represent unreported and untaxed income that, without a system of recorded ownership, the IRS has difficulty reconstructing. Hearings on H.R. 6300 before the House Committee on Ways and Means, 97th Cong., 2d Sess., 35 (1982). The Court held at least some nondiscriminatory federal taxes can be collected directly from the States even though a parallel state tax could not be collected directly from the Federal Government. *South Carolina v. Baker*, 485 U.S. at 523.

<sup>177</sup> Michael Mitchell, Michael Leachman, and Kathleen Masterson, *A Lost Decade in Higher Education Funding*, Center on Budget and Policy Priorities 1 (August 23, 2017) ["A decade since the Great Recession hit, state spending on public colleges and universities remains well below historic levels, despite recent increases. Overall state funding for public two- and four year colleges in the 2017 school year (that is, the school year ending in 2017) was nearly \$9 billion below its 2008 level, after adjusting for inflation."] available at <https://www.cbpp.org/research/state-budget-and-tax/a-lost-decade-in-higher-education-funding>. American Academy of Arts & Sciences, *Public Research Universities' Change in State Funding*, 12 (2015) ["While public higher education in general has been hit by cuts in state support, public research universities have been hit harder. Between 2008 and 2013, inflation-adjusted state appropriation support for public higher education per fte student declined by 26.3 percent in the median public research university. Of the 138 public research universities for which there was comparable data, inflation-adjusted support per fte student declined by more than 20 percent at 98 institutions and declined by more than 40 percent at 29 institutions"] available at

seem unfair, if not counterproductive to impose a federal tax on such schools. However, in reaction to cuts from state sources the leading public institutions have greatly increased their support from private and federal sources.<sup>178</sup>

Several have amassed multi-billion-dollar endowments. The University of Texas System, has the third largest endowment at \$26.5 billion. Other large endowment public universities include: Texas A & M (\$11.6 billion), University of Michigan (\$11 billion), University of California (\$9.8 billion), University of Virginia (\$6 billion), Penn State (\$3.99 billion), and Minnesota (\$3.5 billion).<sup>179</sup>

It is a close question whether public universities with multi-billion-dollar endowments should be included in the investment income tax regime. I would include public institutions. To recognize some of the financial pressures they are under, the trigger point should be increased to \$150 million in investment income, double the private amount. Public schools would have the ability to reduce their taxes as well.<sup>180</sup>

### *Affirmative Action*

In many quarters the phrase “affirmative action” has a pejorative meaning, but the concept remains alive and well in higher education in the form of affirmative action for the affluent. Legacies, also known as the children or close relatives of alumni, often are given a preference in admissions.<sup>181</sup> Children of wealthy individuals or families receive not so secret

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[https://www.amacad.org/multimedia/pdfs/publications/researchpapersmonographs/publicresearchuniv\\_changes\\_instatefunding.pdf](https://www.amacad.org/multimedia/pdfs/publications/researchpapersmonographs/publicresearchuniv_changes_instatefunding.pdf).

<sup>178</sup> In 2016-17, “core funds from the State represented only 24.9% of the University of California’s total operations. While all fund sources are critical to the success of the University, much of the focus of UC’s The University’s “core funds,” comprised of State General Funds, UC General Funds, and student tuition and fee revenue, provide permanent support for the core mission activities of the University, as well as the administrative and support services needed to perform them. Totalling \$7.8 billion strategic budget process and negotiation with the State is dedicated to the levels and use of these core fund sources. State General Funds State General Fund support for UC provides \$3.13 billion in 2016-17, including \$3.04 billion of critical permanent base support for the University’s core mission activities. University of California, Budget for Current Operations 2017-18, 47 (Jan. 2017) available at <http://regents.universityofcalifornia.edu/regmeet/jan17/b1attach2.pdf>.

<sup>179</sup> 2017 NACUOBO-Commonfund Study of Endowments, *supra* note 38.

<sup>180</sup> A third cohort is private secondary schools with endowments of one billion dollars or more. There are three: Hershey School (\$12.5 billion), the Kemehaneha School (\$11.1 billion), and (Phillips Exeter (\$1.1 billion). They should be liable for the tax and be able to offset its impact as well.

<sup>181</sup> Nell Gluckman, *Harvard’s Admissions Process Was Just Dissected in Federal Court. How Did It Hold Up?* Chron. Higher Educ. Nov. 2, 2018 available at [https://www.chronicle.com/article/Harvard-s-Admissions-Process/245003?cid=at&utm\\_source=at&utm\\_medium=en&elqTrackId=073edf581ca143629d7535cd896b8b7e&elq=c901ed78752b4a2094e0c40db607cd29&elqaid=21267&elqat=1&elqCampaignId=10133](https://www.chronicle.com/article/Harvard-s-Admissions-Process/245003?cid=at&utm_source=at&utm_medium=en&elqTrackId=073edf581ca143629d7535cd896b8b7e&elq=c901ed78752b4a2094e0c40db607cd29&elqaid=21267&elqat=1&elqCampaignId=10133).

preferences, as do some children of celebrities and politicians.<sup>182</sup> Even at the most elite institutions, athletes are recruited, and make up a disproportionate percentage of the diversity constituency.<sup>183</sup>

What if institutions affected by the endowment excise tax could reduce the payment of the tax by actions that ameliorated some of the problems of inequality of educational opportunity outlined herein? A public policy decision by Congress could grant schools subject to the excise tax an opportunity to use some of those tax dollars to recruit additional students from underrepresented constituencies. Such a program would be expensive for participating institutions. To be effective, it should consist of more than mere scholarships, but also the necessary academic and psychological support and acculturation programs to prepare these new matriculants for the burdens and anxieties of their experience in higher education.<sup>184</sup>

#### *Provision of a Tax Offset Through Increased Financial Aid*

Under the offset proposal, a school would have to increase its financial aid by more than the percentage of the annual tuition increase. For example, assume the annual tuition increase is 3%. It is likely that the school would increase the financial assistance component of the operating budget by that amount so that students receiving such assistance will not have their

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<sup>182</sup> See, Daniel Golden, *The Story Behind Jared Kushner's Curious Acceptance into Harvard*, ProPublica, Nov. 18, 2016, available at <https://www.dailykos.com/stories/2016/11/21/1602630/-The-Story-Behind-Jared-Kushner-s-urrious-Acceptance-into-Harvard>. Daniel J. Kenny, *The Myth of Meritocratic Admissions at Harvard*, *The Crimson*, Aug. 8, 2017, available at <http://www.thecrimson.com/article/2017/8/8/kenny-myth-meritocratic-admissions/>. In a survey of the class of 2021 nearly three in ten Harvard freshmen have family members or relatives who attended the university. *Meet the Class of 2021*, *Harvard Crimson*, available at <http://features.thecrimson.com/2017/freshman-survey/makeup-narrative>. The seemingly subject nature of admission is suggested in Anemona Hartocollis, Amy Harmon, and Mitch Smith, *Z-Lists, and Other Secrets of Harvard Admission*, *N.Y. Times*, July 30, 2018 at A1, available at <https://www.nytimes.com/2018/07/29/us/harvard-admissions-asian-americans.html>.

<sup>183</sup> Saahil Desai, *College Sports Are Affirmative Action for Rich White Students*, *The Atlantic*, Oct. 23, 2018 [“All applicants to Harvard are ranked on a scale of one to six based on their academic qualifications, and athletes who scored a four were accepted at a rate of about 70 percent. Yet the admit rate for nonathletes with the same score was 0.076 percent—nearly 1,000 times lower. Similarly, 83 percent of athletes with a top academic score got an acceptance letter, compared with 16 percent of nonathletes. Legacy admissions policies get a lot of flak for privileging white applicants, but athletes have a much bigger effect on admissions, and make up a much bigger percentage of the class. And it’s not just Harvard—in 2002, James Schulman and former Princeton University President William Bowen looked at 30 selective colleges and found that athletes were given a 48 percent boost in admissions, compared with 25 percent for legacies and 18 percent for racial minorities.”] available at <https://www.theatlantic.com/education/archive/2018/10/college-sports-benefits-white-students/573688/>.

<sup>184</sup> Despite increasing attendance of students, who were born in the 1970s and 1980s, from lower income groups, it has not led to any meaningful increase in the number of college graduates from those in that income level. In contrast a greater percentage of students from more affluent backgrounds actually graduate than in the past. See, David Leonhardt, *The Growing College Graduation Gap*, *N.Y. Times*, Mar. 26, 2018 at A23.

scholarships cut. The excise tax offset would commence on a one-to-one basis after the 3% increase in financial assistance has been reached in the operating budget for the next year.

*Provision of a Larger Offset Through Increased Recruitment and Admission of Underrepresented Constituencies*

Recruiting additional students from lower income and underserved backgrounds, and other underrepresented constituencies should be rewarded by a greater tax offset. To be successful, it will be expensive for schools that utilize this option. It is insufficient to merely recruit more students from underserved constituencies. These students may have special needs if they are to survive academically and culturally. The marginal cost of each additional student is probably greater than with traditional admissions. Increasing the number of low income and underserved constituencies could be costly. If it is done right, with sufficient expenditures for recruitment, academic, and psychological support that would enable these additional students to fit in academically and at least survive the difficulties of being in such a new environment.

Two of the schools with the largest endowments, Princeton and Yale, already are recruiting underrepresented groups to increase socioeconomic diversity. In fall 2018 Princeton for the first time admitted students from community colleges and announced it will add a new residential college and increase the size of its undergraduate student body with an emphasis on enrolling low-income and first generation students.<sup>186</sup> Yale has gone even further. The University is participating in “the American Talent Initiative’s effort to increase the number of low-income students at top schools by 2025.” It announced it would increase the number of talented first-generation and low-income students enrolled in Yale College. With the opening of two new residential colleges, overall undergraduate enrollment will increase by 200 students per class year. Yale has already increased the number of undergraduates in the entering class who are first-

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<sup>186</sup> See, Melissa Korn, *Colleges Push to Enroll Low-Income Students*, Wall St. J. March 2, 2018 at A3; Amanda Gordon, *Princeton Gets \$65 Million From the Perelmans to Add Undergrads*, Bloomberg, Dec. 5, 2018 available at <https://www.bloomberg.com/news/articles/2018-12-05/perelmans-give-princeton-65-million-to-fund-residential-college?elqTrackId=b26dd541f9524ab9b97daf706a9c40a2&elq=97ed2a0873f04dc4bc4130a261b1b7a7&elqaid=21598&elqat=1&elqCampaignId=10390>.

generation college students by 62 percent in the past five years. In that same period, the number of incoming students receiving Pell grants has grown by 61 percent.<sup>187</sup>

Some schools may not wish to expand their financial aid or to increase the size of their student bodies. That should be their right. The offset would be voluntary. Schools would retain the freedom to set their admission policies and to participate in the offset program or not. If they do not, they would pay the tax. Basically, the offset option attempts to nudge institutions in a public policy direction that will benefit the nation. The taxes collected should be earmarked not for the treasury, but for educational purposes.

### *Conclusion*

A decades' long increase in economic inequality may reverse itself in the future. Amending this faulty legislation in the ways suggested could portend initiatives that would benefit higher education, and our society.

Private institutions have public responsibilities that go beyond educating their students, supporting faculty research, and teaching. It should not be sufficient to say: "Our public service is educating students." That is true, but those receiving these marvelous educational opportunities still represent too narrow a slice of the educational pool. The proposals offered herein will help to address the needs of increasing the number of students from underserved communities to attend elite schools and reverse the country's increasing inequality of educational opportunity.

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<sup>187</sup> Statement of Yale President Peter Solovey, Press Release, American Talent Initiative, *American Talent Initiative Grows to 86 Schools and Nationally Recognized Colleges Share Commitments to Educate More High-Achieving, Low-and Moderate-Income Students*, Dec. 7, 2017 available at <https://www.bloomberg.org/press/releases/american-talent-initiative-grows-86-schools-nationally-recognized-colleges-share-commitments-educate-high-achieving-low-moderate-income-students/>. The American Talent Initiative (ATI), a project funded by Bloomberg Philanthropies, brings top colleges and universities together with the philanthropy and research communities to expand access and opportunity for talented low- and moderate-income students. Over ninety schools are members. By 2025, ATI aims to attract, enroll, and graduate an additional 50,000 lower-income students at the 290 colleges and universities that consistently graduate at least 70 percent of their students in six years.



## Appendix 1

Effective: February 9, 2018

26 U.S.C.A. § 4968, I.R.C. § 4968

### § 4968. Excise tax based on investment income of private colleges and universities

**(a) Tax imposed.**--There is hereby imposed on each applicable educational institution for the taxable year a tax equal to 1.4 percent of the net investment income of such institution for the taxable year.

**(b) Applicable educational institution.**--For purposes of this subchapter--

**(1) In general.**--The term "applicable educational institution" means an eligible educational institution (as defined in section 25A(f)(2))--

**(A)** which had at least 500 tuition-paying students during the preceding taxable 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

**(D)** 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.

**(2) Students.**--For purposes of paragraph (1), the number of students of an institution (including for purposes of determining the number of students at a particular location) 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).

**(c) Net investment income.**--For purposes of this section, net investment income shall be determined under rules similar to the rules of section 4940(c).

**(d) Assets and net investment income of related organizations.**--

**(1) In general.**--For purposes of subsections (b)(1)(C) and (c), assets and net investment income of any related organization with respect to an educational institution shall be treated as assets and net investment income, respectively, of the educational institution, except that--

**(A)** no such amount shall be taken into account with respect to more than 1 educational institution, and

**(B)** unless such organization is controlled by such institution or is described in section 509(a)(3) with respect to such 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 shall not be taken into account.

**(2) Related organization.**--For purposes of this subsection, the term “related organization” means, with respect to an educational institution, any organization which--

**(A)** controls, or is controlled by, such institution,

**(B)** is controlled by 1 or more persons which also control such institution, or

**(C)** is a supported organization (as defined in section 509(f)(3)), or an organization described in section 509(a)(3), during the taxable year with respect to such institution.

**CREDIT(S)**

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26 U.S.C.A. § 4968, 26 USCA § 4968

Current through P.L. 115-122. Also includes P.L. 115-125 to 115-129. Title 26 current through 115-129.