

ARTICLES

HOW BIG IS TOO BIG: SHOULD CERTAIN HIGHER EDUCATIONAL ENDOWMENTS' NET INVESTMENT INCOME BE SUBJECT TO TAX?

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INTRODUCTION

Section 13701 of the 2017 Tax Reform statute¹ created new Internal Revenue Code § 4968 that imposes a 1.4% excise tax on the net invest-

¹ Act of Dec. 20, 2017, Pub. L. No. 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, and allows legislation to avoid a filibuster in the Senate. Under the rule, reconciliation bills cannot include provisions that do not 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, 6:04 PM), <http://thehill.com/policy/finance/365691-senate-parliamentarian-rules-against-gop-tax-bills-name>.

ment income of certain billion-dollar private college and university endowments.² The affected institutions must have:

- (a) at least 500 tuition-paying³ students during the preceding taxable year (provided more than 50% of its students are located in the United States),⁴ 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.⁵

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.⁶ Public colleges and universities are not subject to this tax.⁷ Approximately thirty to thirty-five institutions will be affected initially by the legislation.⁸ As institutions' endowment assets

² Eligible educational institutions are schools offering education beyond high school and eligible to participate in a program under title IV of the Higher Education Act of 1965, which provides student financial aid by the U.S. Department of Education. I.R.C. § 25A(f)(2) (2016). The full text of I.R.C. § 4968 (2018) is included in Appendix I.

³ "Tuition paying" was added to the legislation in the February 2018 Bipartisan Budget Act, Pub. L. No. 115-123, 132 Stat. 64 (2018) to exempt Berea College from the excise tax.

⁴ The "more than fifty percent of students located in the United States" requirement 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.

⁵ 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.

⁶ Related organizations are: (1) controlled by the institution, or (2) a supported organization described in I.R.C. § 509(f)(3) (2012), or (3) a supporting organization described in I.R.C. § 509(a)(3) (2012) 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.

⁷ I.R.C. § 4968(b)(1)(c) (2018) states that "applicable educational institution" excludes state colleges and universities by reference to I.R.C. § 511(a)(2)(B) (2018). 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."

⁸ See Andrew Kreighbaum, *Final GOP Deal Would Tax Large Endowments*, INSIDE HIGHER EDUCATION (December 18, 2017), <https://www.insidehighered.com/news/2017/12/18/>

grow, additional colleges and universities will become subject to the tax.⁹ The new tax is effective for taxable years beginning after December 31, 2017.¹⁰ As most educational foundations operate on a July 1 to June 30th fiscal year, the first year the investment income tax will apply will be fiscal year 2019.¹¹ 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. Further, this Article 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 Article, Harvard, Princeton and Yale are used as examples. They have been chosen for their success, not as a criticism. Harvard has the largest endowment, Princeton has the most endowment assets per student, and over time, Yale has demonstrated the best investment prowess.

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_1fcbc04421-39cce06ca0-226888949&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 (Apr. 3, 2018), <https://www.forbes.com/sites/amesbrown/2018/04/03/tax-reform-college-endowments/#47e4f2381bc3>.

⁹ 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*, INSIDE HIGHER EDUCATION (Jan. 4, 2018), <https://www.insidehighered.com/news/2018/01/04/dozens-more-colleges-will-pay-endowment-taxes-if-growth-rates-continue>.

¹⁰ 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. Rev. Rul 2018-55 C.B. 773; Rev. Proc. 2018-26 I.R.B. 773; Rev. Rul. IR 2018-134 I.R.B. 316. This stepped-up basis should reduce net investment income for assets held for many years that have appreciated over time.

¹¹ *Id.*

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

A. *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.¹² Organizations with large endowments, such as colleges, universities, and private foundations,¹³ all finance a significant part of their operations through the returns received from the investment of this capital.

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 on the other hand, are not subject to donor-imposed restrictions. Finally, temporarily restricted net assets consist of donor-restricted endowment funds that are not classified as permanently restricted net assets.¹⁴ When donor restrictions expire—a stipulated time

¹² 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).

¹³ Private foundations are charities that have failed certain tests of public support under the Internal Revenue Code. For the 2014 tax year, 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, <https://www.irs.gov/statistics/soi-tax-stats-domestic-private-foundation-and-charitable-trust-statistics>. See generally I.R.C. § 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).

¹⁴ 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

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.¹⁵

B. *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. Net investment income is defined as gross investment income¹⁶ plus capital gain income minus allowable deductions.¹⁷

C. *The Rationale of Endowments*¹⁸

Intergenerational equity is the most commonly stated goal for endowment management. As stated by the Nobel Prize winning economist James Tobin, “[t]he 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.”¹⁹ 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

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 (2016).

¹⁵ See Financial Accounting Standards Board, Staff Position No. FAS 117-1. The restrictive spending policies of Uniform Prudent Management of Institutional Funds Act (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 YEAR 2017, 16 (2017), <https://finance.harvard.edu/annual-report>. 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), <https://your.yale.edu/work-yale/financial-management/accounting/financial-reports>.

¹⁶ 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 (2018). Such term also includes income from sources similar to those in the preceding sentence. Treas. Reg. § 53.4940-1 (1992).

¹⁷ 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) (2007).

¹⁸ 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, 202-09 (2014), <http://digitalcommons.pace.edu/lawfaculty/958/>.

¹⁹ 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.

to smooth out revenue shortfalls and maintain the same scale of activities in lean years as well as in bountiful ones.²⁰ The financial crisis of 2008–2009 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.²¹

D. 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.²² Growth was achieved primarily through additional gifts, and endowment funds were invested quite conservatively. English law encouraged this approach; there were legal lists of securities, principally governmental securities, which were presumably safe investments in which trustees could invest.²³

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.²⁴ 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.²⁵ Investment practices changed at some institutions after the First World War. In the 1920s, as the stock market rose, many en-

²⁰ Robert C. Merton, *Optimal Investment Strategies for University Endowment Funds*, 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).

²¹ See Conti-Brown, *supra* note 20, at 702–03. Jeffrey R. Brown et al., *How University Endowments Respond to Financial Market Shocks: Evidence and Implications*, 104 AMER. ECON. REV. 931, 949–56 (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.

²² 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], <http://www.tellus.org/publications/files/endowmentcrisis.pdf>.

²³ BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE, 11 (1986).

²⁴ Dobris, *supra* note 12, at 54–55.

²⁵ Tellus Report, *supra* note 22, at 18.

dowments invested in high-yielding bonds and common stocks.²⁶ The experience of the Yale endowment is illustrative: during the 1920s, the Yale endowment invested over one half of its assets in equities.²⁷ In 1930, equities represented 42% of the Yale endowment portfolio, whereas the average college or university had only 11%.²⁸

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.²⁹ 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. . ."³⁰ 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.³¹ Yale then substantially increased its exposure to equity investments, as did other colleges and universities.³² 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.³³ The changes in endowment asset allocation did not result from a serendipitous recognition by endowment managers who had read the work of financial economists and had concluded equities over time were a sounder investment than bonds. Rather, endowment managers adopted new paradigms of portfolio management and spending policies.

E. *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,³⁴ one of which was more liberal spending policies through what

²⁶ *Id.* at 17–18.

²⁷ Josh Lerner, *Yale University Investments Office: August 2006*, 2 (Harv. Bus. School Case Study 9-807-073) (Rev. 2011).

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* At this time, the treasurer and trustees managed the endowment themselves, selecting individual bonds and high-yield stocks for the portfolio.

³¹ *Id.*

³² *Id.*

³³ 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).

³⁴ Hansmann, *supra* note 20, 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), <https://www.commonfund.org/InvestorResources/Publications/White%20Papers/Sources%20of%20Endowment%20Growth.pdf>.

was termed “total return policies,” which permitted the expenditure of capital gains as well as traditional investment income.³⁵ 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.³⁶

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, thus offering a reliable income stream, diversified their portfolios by allocating more to domestic and international equities and a wide range of alternative investments.³⁷ Concurrently, there arose an increasing use of external professional investment managers, acolytes of the principles of Modern Portfolio Theory (MPT), who provided the intellectual foundation for a new aggressive approach to endowment management.³⁸

MPT 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 single type of asset or decision concerning that asset.³⁹

³⁵ LONGSTRETH, *supra* note 23, 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.

³⁶ According to a 2015 Congressional Research Service Report, institutions with larger endowments use, on average, more of their endowment funds in their annual operating budget. In fiscal year 2014, 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 ET AL., CONGR. RES. SERV., *College and University Endowments: Overview and Tax Policy Options*, (2015) citing NACUBO-Commonfund Study of Endowments 50 (2014) [hereinafter *College and University Endowments: Overview and Tax Policy Options*], <https://fas.org/sgp/crs/misc/R44293.pdf>.

³⁷ 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 (2017) [hereinafter NCSE], <http://www.nacubo.org/Documents/about/pressreleases/2017-NCSE-Press-Release.pdf>.

³⁸ Tellus Report, *supra* note 22, at 19.

³⁹ *Id.*

In common parlance, risk is the chance of loss. In finance, risk refers to volatility of return.⁴⁰ 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.⁴¹ Diversification moderates risks that are inherent in investing and reduces risks that are not justified by the prospect of gain. A fiduciary has the responsibility of reducing or minimizing risk that can be avoided.⁴²

⁴⁰ Financial economists use risk to describe variation when the probabilities of possible outcomes are known. Professor Lynn Stout differentiated 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.

⁴¹ The phrase is very old, and its origin is unknown. In 1666, Giovanni Torriano, in the *Second Alphabet of Proverbial Phrases*, stated, "[t]o 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 from which it purchased life insurance policies on older OSU alumni. The hedge fund lost most of its value, and OSU alumni declined to die in a 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.

⁴² UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 4(e)(4) (2006); UNIF. PRUDENT INVESTOR ACT § 3 (1994).

F. *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.⁴³

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.⁴⁴ Basically, an alternative investment is one that is not cash, stocks, or bonds—the three traditional asset classes.⁴⁵ 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.⁴⁶ The justification for this approach is explained by one of the endowment model’s most respected and successful practitioners, David F. Swenson, Chief Investment Officer of the Yale Endowment:

⁴³ JANE L. MENDILLO, HARVARD MANAGEMENT COMPANY ENDOWMENT REPORT 3 (2010), 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. *See also, College and University Endowments: Overview and Tax Policy Options*, *supra* note 36, at 14. 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.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ 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.

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.⁴⁷

However, these same alternative investments may offer little transparency or liquidity, carry higher risks than traditional asset classes, and may involve speculative trading strategies.⁴⁸ 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 from 1990 to 2007 by 644%, Princeton's by 525%, and Yale's by 677%. From 2001 to 2007, higher education endowments grew annually by double-digit figures.⁴⁹

⁴⁷ Yale Investments Office, *Our Strategy*, <http://investments.yale.edu/our-strategy-2/>. "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. The Endowment's long-time horizon is well suited to exploiting illiquid, less efficient markets such as venture capital, leveraged buyouts, oil and gas, timber, and real estate."

⁴⁸ Tellus Report, *supra* note 22, 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 20, 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.

⁴⁹ At the end of the editing process, the fiscal 2018 survey was published. A summary of the latest results are as follows:

According to the 2018 fiscal year NACUOBO-TIAA Survey consisting of the endowment results of 802 U.S. institutions, the average endowment increase was 8.2% compared to 12.2% in fiscal year 2017. There were 106 endowments with assets of \$1 billion or more. Nearly half of the assets that colleges withdrew from their endowments were allocated to scholarships or other financial aid programs. Two thirds of the reporting institutions increased their spend rates from the previous year. The median increase of these institutions was 6.6%.

Among the top twenty endowments, the University of Texas moved up to number two behind Harvard with Yale falling to third. Other changes included the University of California moving to eleventh, changing places with Columbia in twelfth; and the University of Chicago rising to fifteenth, replacing Washington University of St. Louis, now sixteenth. NACUOBO-TIAA, *Which Colleges Have the Largest Endowments?*, Chron. Higher Educ., Jan. 31, 2019, https://www.chronicle.com/article/Which-Colleges-Have-the/245587?cid=at&utm_source=at&utm_medium=en&elqTrackId=c4241e7b88324c8b92a2370336e6ab42&elq=bd373c7b7e7a4.

TABLE 2
INCREASE IN ASSETS OF LEADING ENDOWMENTS 1990–2007

School	1987 Endowment	2007 Endowment	Percentage Increase
Harvard	4,018,270	34,634,906,000	762%
Yale	2,098,400	22,530,200,000	974%
Stanford	1,676,950	17,164,836,000	924%
Princeton	2,291,110	15,787,200,000	589%
University of Texas	2,829,000	15,613,672,000	451%
MIT	1,169,740	9,980,410,000	753%
Columbia	1,387,060	7,149,803,000	415%
University of Michigan	287,539	7,089,830,000	2366%
University of Pennsylvania	648,528	6,635,187,000	923%
Texas A+M*		6,590,300,000	-

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

II. CONGRESSIONAL AND ACADEMIC SCRUTINY

A. *The Largest Endowments Come under Criticism*

Criticism of large, charitable endowments is nothing new. Forty-five years ago, the Omaha 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.⁵⁰

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).⁵¹

⁵⁰ It remains one of the richest such organizations with an endowment now topping \$900 million. See Megan O’Neil, *From Boys Town to Harvard: Big Endowments in the Cross Hairs*, CHRON. PHIL., Aug. 1, 2017, <https://www.philanthropy.com/article/From-Boys-Town-to-Harvard-Big/240771?elqTrackId=13de749a86eb4e1eab831ec0aaf0f22e&elq=99ca044fae9e4dadb7828faeaf090f9&elqaid=16196&elqat=1&elqCampaignId=7002>.

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

Among those testifying were Dr. Jane Gravelle of the Congressional Research Service and Lynne Munson of the Center for College Affordability.⁵² 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.⁵³ Though no legislation resulted, Senator Charles Grassley (R- IA) 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.⁵⁴ In 2007, he suggested that large endowments should have a mandatory 5% payout, the same figure that applied to private foundations.⁵⁵

In January 2008, the Senate Finance Committee via a letter from Senators Max Baucus (D-MT) 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%.⁵⁶ 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.⁵⁷

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, that did

⁵² *Offshore Tax Issues: Reinsurance and Hedge Funds Hearing Before The Senate Committee On Finance*, 110th Cong. (2007). (Statement of Dr. Jane G. Gravelle), <https://www.finance.senate.gov/imo/media/doc/515631.pdf>.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ 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 also, I.R.C. § 4942(e)(1) (2017), which requires private foundations to spend at least 5% of their current investment asset value for charitable purposes annually.

⁵⁶ Karen W. Aronson, *Senate Looking at Endowments As Tuition Rises*, N.Y. TIMES, Jan. 25, 2008, at A1.

⁵⁷ Doug Lederman, *Senators Scrutinize Well-Endowed Colleges*, INSIDE HIGHER ED., Jan. 25, 2008, <https://www.insidehighered.com/news/2008/01/25/senators>. The author's first job in college was washing dishes in a dining hall.

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 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.⁵⁸

In February 2008, the House, with bipartisan support, passed the higher Education Opportunity Act that, established 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 5% of their assets each year was withdrawn, but another amendment, passed by a voice vote, required colleges to report how much of their endowments they spend to keep students’ costs down.⁵⁹

B. *The Market Drop of 2009*

In the fiscal year ending June 30, 2008, higher education endowments lost 3% 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%).⁶⁰ A survey of over 800 higher education institutions showed average losses of 18.7%, the worst rate of return since the Great Depression.⁶¹ 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, and a

⁵⁸ Chaker, *supra* note 55.

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

⁶⁰ 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 (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.).

⁶¹ Kenneth E. Redd, *To Ensure We Endure*, BUSINESS OFFICER, July/Aug. 2012, http://www.nacubo.org/Business_Officer_Magazine/Magazine_Archives/JulyAugust_2012/To_Ensure_We_Endure.html.

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

C. Recovery and Renewed Criticism

In the aftermath of the 2008 market drop, securities prices recovered. 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. 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.⁶³ Their spend rates ranged from 4%–5% annually.

TABLE 3
GROWTH OF ENDOWMENTS 2007–2017*

	2007	2017	Percentage Increase
Harvard	\$34.635	\$37.1	7.1%
Princeton	\$15.787	\$23.812	50.8%
Yale	\$22.530	\$27.176	20.6%

*Figures in billions of dollars, rounded off to the nearest million. Source 2007, 2017 NACUOBO Studies of Endowments, 2007, 2017, NACUOBO Archives, available at <https://www.nacubo.org/research/2018/nacubo-commonfund-study-of-endowments>.

⁶² Harvard University Financial Report Fiscal Year 2017, at 5; Report of the Treasurer, Princeton University 2017, 13; Princeton 2017 Treasurer's Report 16, <https://finance.princeton.edu/princeton-financial-overv/report-of-the-treasurer/>; 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 institutions with smaller endowments. In fiscal year 2014, 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, at 50. *College and University Endowments: Overview and Tax Policy Options*, *supra* note 36, at note 26.

⁶³ Megan O'Neil & Joshua Hatch, *Many Big Nonprofits Rapidly Stockpiling Endowment Cash Chronicle Data Shows*, *CHRON. PHIL.*, July 26, 2017, <https://www.philanthropy.com/article/Many-Big-Nonprofits-Rapidly/240753>. By 2017, Harvard's endowment increased to \$37.1 billion (46.6%), Princeton's to \$23.8 billion (105%) and Yale's 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, <https://harvardmagazine.com/2017/11/taxing-university-endowments>.

TABLE 3A
GROWTH OF ENDOWMENTS 1987–2017*

	1987	2017	Percentage Increase
Harvard	\$4.02	\$37.1	823%
Princeton	\$2.29	\$23.812	940%
Yale	\$2.10	\$27.176	1194%

*Figures in billions of dollars, rounded off to the nearest million. Source 2007, 2017 NACUOBO Studies of Endowments, 2007, 2017, NACUOBO Archives, available at <https://www.nacubo.org/research/2018/nacubo-commonfund-study-of-endowments>.

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 fiscal year 2017 indicated that while participating institutions' endowments returned an average of 12.2% (net of fees) compared with -1.9% for fiscal year 2016, the standard ten-year look back, or trailing ten-year average, for all educational endowments was only 4.6%.⁶⁴ 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%. 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.⁶⁵ These results call into question the endowment model of investing's heavy reliance on alternative investments.⁶⁶

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.⁶⁷ Percentage wise, there is little difference in spend rates be-

⁶⁴ *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 [hereinafter NCSE], <http://www.nacubo.org/Documents/about/pressreleases/2017-NCSE-Press-Release.pdf>.

⁶⁵ 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. See also, James B. Stewart, *Returns Lag, but Ivy Colleges Cling to Investment Strategy*, N.Y. TIMES, Dec. 13, 2018, at B3.

⁶⁶ Returns were diminished because of the weak performance of hedge funds, venture capital, and private equity. The average billion-dollar endowment lost \$47 million over ten years, not to speak of the fees paid to the firms that manage the alternate investments. Billion-dollar endowments invested more than five times as much in alternative strategies as endowments less than \$25 million. To add insult to injury, the ten-year average returns of the under \$25 million endowments were the same as the average of billion-dollar endowments, 5%. *Id.*

⁶⁷ 2017 NACUBO-Commonfund Study of Endowments, Average Annual Effective Spending Rates for U.S. College and University Endowments and Affiliated Foundations, Fis-

tween endowment sizes, save for the very smallest endowments.⁶⁸ Small differences in spending rates occurred by size and type of endowment.⁶⁹ The spending rate for all 809 institutions in the 2017 NACUBO-Commonfund survey was 4.4%.⁷⁰ 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.⁷¹

Despite relatively small differences in spending rate between endowments on the basis of size, a larger endowment will have more dollars to spend after it receives its returns on investment, by virtue of its size.⁷² 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.

In 2014, Representative David Camp (R-MI), 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 2017,⁷³ a proposed a 1% 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 proposals discussed was one by Representative Tom Reed (R-NY), who proposed, but did not introduce, legislation that would mandate colleges with over \$1 billion endowments to 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 and Harvard, whose investment management firms can earn billions in returns annually, also distribute their unused excess funds to other institutions.⁷⁴

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 the economic situations

cal Years 2017 to 2008, <https://www.nacubo.org/-/media/Nacubo/Documents/EndowmentFiles/2017-NCSE-Public-Tables—Spending-Rates.ashx?la=en&hash=E1CE49F8E652B8C705F4414073B80E21DF1CFEE>.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² 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.

⁷³ Act of Dec. 20, 2017, Pub. L. No: 115-97, *supra* note 1.

⁷⁴ Janet Lorin & Lauren Streib, *House Panel Questions College Endowment Spending, Tax Benefits*, BLOOMBERG, Oct. 7, 2015, <https://www.bloomberg.com/news/articles/2015-10-07/house-panel-questions-college-endowment-spending-tax-benefits>.

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.⁷⁵

In February 2016, the Senate Finance Committee and the House Ways and Means Committee sent letters to fifty-six private schools with assets greater than \$1 billion. The letter signed by Senator Orrin Hatch (R-UT) and Representatives Kevin Brady (R-TX) and Peter Roskam (R-IL) 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. 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.⁷⁶

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 offshore havens, such as the Cayman Islands, through the use of "blocker corporations."⁷⁷

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.⁷⁸ To avoid this taxation, and indirectly acknowledging the fact that many of these investments, such as fossil fuels or open-pit mining operations, would be politically incorrect on campus, the endowments established blocker corporations as intermediaries between themselves and their investing part-

⁷⁵ Representative Reed introduced legislation in May 2018 that would waive the new tax if they spend 25% 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>.

⁷⁶ Janet Lorin, *Rich Schools Queried by U.S. Lawmakers on Endowment Spending*, BLOOMBERG, Feb. 9, 2016, <https://www.bloomberg.com/news/articles/2016-02-09/richest-schools-queried-by-u-s-lawmakers-on-endowment-spending>.

⁷⁷ Stephanie Saul, *Endowments Boom as Colleges Bury Earnings Overseas*, N.Y. TIMES, Nov. 8, 2017, <https://www.nytimes.com/2017/11/08/world/universities-offshore-investments.html>.

⁷⁸ 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.

ners. Blocker corporations 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.⁷⁹ Not surprisingly, endowments that use this technique, which avoids millions of dollars in taxes that would otherwise 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.

D. *Academic Inquiry of Large Endowments*

1. 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 on the future?

In three thoughtful articles, Professor Daniel Halperin examined tax policy and endowments.⁸⁰ He concluded that while exemption for contributions or gifts is consistent with a normal income tax, exemption for investment income is not.⁸¹ Income tax exemption for investment income of charities is a departure from normal tax privileges, and is a subsidy.⁸² 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.⁸³ 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

⁷⁹ See Saul, *supra* note 77. 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 (2010). See also, *College and University Endowments: Overview and Tax Policy Options*, *supra* note 36, at 16.

⁸⁰ Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283 (2011); Halperin, *Tax Policy and Endowments—Is Excessive Accumulation Subsidized?*, 67 EXEMPT ORG. TAX REV. 17 (Jan. 2011); and Halperin, *Tax Policy and Endowments—Is Excessive Accumulation Subsidized? (Part II)* 67 EXEMPT ORG. TAX REV. 125 (Feb. 2011).

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

favor of current spending, or at least limit the subsidy for excessive accumulation.⁸⁴

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 endowment's level of the contribution to support university programs, 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 a lack of support for the charitable purpose. Third, there appears to be a tendency, or at least a desire, 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.⁸⁵ 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.⁸⁶

Professor Edward A. Zelinsky believes first that there is a strong tax policy argument for taxing the net investment income of all charitable endowments no matter their size, and second 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.⁸⁷ 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.⁸⁸ 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.⁸⁹ 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.⁹⁰

⁸⁴ Halperin, *supra* note 80, at 17.

⁸⁵ Halperin *Part II*, *supra* note 80, at 67.

⁸⁶ *Id.*

⁸⁷ Edward A., Zelinsky, *Section 4968 and Taxing All Charitable Endowments: A Critique and Proposal*, 38 VA. TAX REV. 141 (2018).

⁸⁸ *Id.* at 142.

⁸⁹ *Id.*

⁹⁰ *Id.*

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 schools without large endowments to compete for students and faculty. 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.⁹¹ The net income exemption for smaller endowments is a modest effort to reduce the inequalities between educational institutions and their students.

2. Endowment Spending Policies

Endowment spending policies have been matters of widespread academic commentary and disagreement.⁹² The average spend rate of all institutions in the 2017 NACUBO-Commonfund Survey was 4.4%, and for the billion-dollar endowments, 4.8%.⁹³ Harvard's 2017 spend rate

⁹¹ *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 "much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income." Under this theory, Congress has great authority in fashioning tax legislation. It can both 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.

⁹² 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 21; 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. L. REV. 1143 (2016); Hansmann, *supra* note 20, at 3, 40; Sarah E. Waldeck, *The Coming Showdown Over University Endowments: Enlisting the Donors*, 77 FORDHAM L. REV. 1795 (2009); Halperin, *supra* note 80; Halperin *Parts I & II*, *supra* note 80; Calvin H. Johnson, *Payout by Charities Over 50 Years*, TAX NOTES 1161, Sept. 12, 2011; Akash Deep & Peter Frumkin, *The Foundation Payout Puzzle* (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 9, 2005), <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=karenwarens>.

⁹³ 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 cam-

was 5.4%, Princeton's 5%, and Yale's 5.25%.⁹⁴ 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.⁹⁵ He also proposed that the limit on the charitable deduction for at least some gifts to endowments should be reduced to at least to the level applicable to gifts to private foundations.⁹⁶ Further, he recommended an examination into whether the current tax law encourages excessive borrowing.⁹⁷

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.⁹⁸ 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 8% of their endowments annually.⁹⁹ 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.¹⁰⁰ His argument for increased spending

pus operations, as determined and defined by each institution. The rate is calculated net of investment fees and expenses for managing the endowment. 2017 NCSE, *supra* note 37.

⁹⁴ Harvard Financial Report *supra* note 15, at 34; Princeton 2017 Treasurer's Report *supra* note 62, at 16; Yale Financial Report, *supra* note 15, at 17.

⁹⁵ Halperin (*Part II*), *supra* note 81.

⁹⁶ Other scholars have gone further. Sarah Waldeck recommended denying a charitable deduction for some gifts. See Waldeck, *supra* note 93, at 1818–22. 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).

⁹⁷ Halperin *Part II*, *supra* note 81.

⁹⁸ See Victor Fleischer, *Stop Universities From Hoarding Money*, N.Y. TIMES, Aug. 19, 2015, <https://www.nytimes.com/2015/08/19/opinion/stop-universities-from-hoarding-money.html>.

⁹⁹ *Id.*

¹⁰⁰ 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, <https://www.bloomberg.com/news/articles/2017-04-09/yale-en-dowment-blasts-low-fee-crusaders-says-returns-would-sag>. A Detroit Free Press investigation

underplays the volatility of large endowment investment policies, which makes an 8% payout risky, and at an amount above the Uniform Management of Institutional Funds Act's recommended maximum spend rate of 7%.¹⁰¹

To increase the returns in a low-interest-rate 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.¹⁰² 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.¹⁰³

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, *University of Michigan Pours Billions into Funds Run by Contributors' Firms*, DETROIT FREE PRESS, Feb. 1, 2018, <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>.

¹⁰¹ The UPMIFA § 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.

¹⁰² Brody, *Charitable Endowments and the Democratization of Dynasty*, *supra* note 92.

¹⁰³ Galle, *supra* note 92.

III. THE ENDOWMENT EXCISE TAX

A. *The House Bill and the Reaction of the Institutions Affected*

The House's proposed tax reform bill was more punitive to higher education than was the final legislation.¹⁰⁴ It taxed tuition benefits for employees, graduate students and employees' dependents.¹⁰⁵ Deductions for student loans, interest, and tax-free financing for private college and university capital projects would be eliminated.¹⁰⁶ The original endowment excise tax would apply to institutions with \$250,000 of endowment per full-time-equivalent students, which would have affected over sixty educational institutions.¹⁰⁷ 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 \$500,000.¹⁰⁸

Unsurprisingly, the higher education community was against the excise tax. While some criticisms 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

¹⁰⁴ Tax Cuts and Jobs Act, H.R.1, 115th CONG. (2017). *See also*, Nick Anderson, *Tax Bill Reflects Rift Between Many Republicans and Higher Education*, WASH. POST, Nov. 19, 2017, 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.

¹⁰⁵ *Id.* at § 1203.

¹⁰⁶ *Id.* at § 1204.

¹⁰⁷ *Id.* at § 5103. Section 5206 of Representative Dave Camp's discussion draft of the Tax Reform Act of 2014 (Feb. 21, 2014), was the template for the House's tax reform bill two years later, providing 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 CONG., 2d Session § 5206, 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, https://www.chronicle.com/article/if-republicans-get-their-way/241659?cid=wcontentlist_hp_latest; Andrew Kreighbaum, *Final GOP Deal Would Tax Large Endowments: House and Senate Negotiators Release Final Details of Tax Reform Agreement Expected to Win approval*, INSIDE HIGHER EDUCATION, Dec. 18, 2017, https://www.insidehighered.com/news/2017/12/18/large-endowments-would-be-taxed-under-final-gop-tax-plan#disqus_thread.

¹⁰⁸ The tax threshold was increased to protect Hillsdale College, notable for its political views and refusal to accept federal assistance.

institutions with large endowments primarily used to fund financial aid.¹⁰⁹

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 restricted funds are limited to scholarship assistance, and as Table 4 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.¹¹⁰

TABLE 4
ALLOCATION OF ENDOWMENT FUNDS AT HARVARD,
PRINCETON, AND YALE*

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Harvard ¹¹¹	\$6,148,173	\$23,032,044	\$7,916,257	\$37,096,474
Princeton ¹¹²	\$10,649,353	\$11,921,478	\$2,041,247	\$24,803,503
Yale ¹¹³	\$4,573,133	\$20,251,572	\$3,901,251	\$28,986,158

*In thousands of dollars.

There was apprehension 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.

A common objection 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

¹⁰⁹ The archetypal example is Berea College, which uses approximate 75% of its endowment spend rate for scholarships for students.

¹¹⁰ The amount of unrestricted funds will increase enormously when the “temporarily restricted” category is eliminated under FASB Accounting Standards Update 2016–2014, *supra* note 14.

¹¹¹ 2017 Harvard Financial Report, *supra* note 15, at 16.

¹¹² Princeton Treasurer’s Report, *supra* note 61, at 23.

¹¹³ 2017 Yale Financial Report, *supra* note 15, at 54. Figures combine Donor restricted funds and board designated endowment.

nineteenth century.¹¹⁴ Currently, government controls partners through requirements concerning the use of the immense amount 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 10% gain on its net investment income is \$34 million.¹¹⁵ 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 university's endowment or programs.

B. *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

¹¹⁴ The relationship between government 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-twentieth century formalized the 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.

¹¹⁵ See John S. Rosenberg, *Endowments: The Specter of Taxation*, HARV. MAG., Nov. 6, 2017, <https://harvardmagazine.com/2017/11/taxing-university-endowments>; N. Gregory Mankiw, *Who Loses When Endowments are Taxed*, N.Y. TIMES, Dec. 24, 2017, at BU4. 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.

country, Republicans express increasingly negative views over the impact of higher educational institutions.¹¹⁶ Student protests at certain schools, which disrespected the ideals of free speech, may have incensed many. This, combined with the idea 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.¹¹⁷

Given these opinions, the endowment excise tax may not be based on the ostensible policy justifications of tuition relief and improved 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.¹¹⁸

C. *Ambiguities in the Legislation*

1. 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 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 day

¹¹⁶ Pew Research Center, *Sharp Partisan Divisions in Views of National Institutions*, July 10, 2017, 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.*

¹¹⁷ In the 2016 presidential election, Donald Trump took two-thirds of the non-college white vote. College graduates favored Hillary 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, <https://www.chronicle.com/article/A-Humbling-of-Higher-Ed/238378>.

¹¹⁸ 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). *See* Pew Research Center, *supra* note 116.

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.”¹¹⁹ 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”?¹²⁰ 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.

2. 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.¹²¹

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 in-

¹¹⁹ Stephen Briggs, president of Berry College in Georgia, which expects to pay the tax in the near future, stated, “[w]e would argue that there’s nothing that we generate that’s not used to carry out the institution’s educational purposes.” See Richard Rubin & Andrea Fuller, *Small Colleges Take Big Hit From Tax Law*, WALL ST. J., Jan. 19, 2018, at A1.

¹²⁰ *Id.*

¹²¹ 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% in the year through June 30, trailing the average 12.2% 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, <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 and changed its compensation approach. Harvard Financial Report, *supra* note 15, at 8.

vestment 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, the NACUBO-Commonfund surveys of U.S. college and university endowments showed 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. The other years' returns were positive ranging from 2.4% in 2015 to 19.2% in 2011.¹²² 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.¹²³ This should reduce investment income in the first few years that the excise tax will be imposed in comparison to a scenario in which the actual purchase price of the investment was the basis.

3. 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 the 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 will likely 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.¹²⁴

4. 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.¹²⁵ Assume a college has a one-billion-dollar endowment and six hundred students.

¹²² Rick Seltzer, *Endowments Rebound, but Is It Enough*, INSIDE HIGHER ED, Jan. 25, 2018 (citing Fiscal Years 2016-2017 NACUBO-Commonfund Study of Endowments), <https://www.insidehighered.com/news/2018/01/25/college-endowments-rise-122-percent-2017-expects-worry-about-long-term-trends>.

¹²³ See discussion *supra* note 10.

¹²⁴ 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, *supra*, note 9. Lower estimates reflect a growth rate of 4%; the higher estimate assumes a growth rate of 8%.

¹²⁵ See *supra* note 1.

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

A. *The Legislation is Over-inclusive and Under-inclusive*

1. 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. Senator Grassley and others suggested that endowments be subject to mandatory minimum spending rates of 5% of assets, the same as required of private foundations.¹²⁶ 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.¹²⁷ A payout requirement applied to all institutions, regardless of endowment size, could impose a greater burden on institutions with smaller endowments.¹²⁸

In 1969, private foundations were required to make distribution payouts because of both the concern that many were created to avoid taxes and protect control of businesses, and the belief that their resources entered the charitable stream more slowly than those of public chari-

¹²⁶ *College and University Endowments: Overview and Tax Policy Options*, *supra* note 36, at 16–17. Janet Lorin & Loren Streib, *House Panel Questions College Endowment Spending, Tax Benefits*, BLOOMBERG, Oct. 7, 2015, <https://www.bloomberg.com/news/articles/2015-10-07/house-panel-questions-college-endowment-spending-tax-benefits>. See also, I.R.C. § 4942 (2017). Private foundations must make annual qualifying distributions in an amount equal to 5% 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.

¹²⁷ 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).

¹²⁸ *Id.* at 606, 615.

ties.¹²⁹ Private foundations usually are established to assist others outside the foundation, whereas endowments are usually established as instruments to assist a university achieve its mission in the way its board deems most suitable.¹³⁰

Another difference between private foundations and endowments 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.¹³¹ Examining the ten-year trailing returns of the billion-dollar endowments, one finds there are lean years along with plentiful ones. The endowment's board and university trustees have a fiduciary responsibility 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%.¹³² 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.¹³³ 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.¹³⁴

¹²⁹ 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 within a certain period of time. See James Andreoni, *The Benefits and Costs of Donor Advised Funds*, 32 TAX POLICY AND THE ECONOMY 1, 2018; Ray D. Madoff, *It's Time to Reform Donor-Advised Funds*, 69 EXEMPT ORG. TAX REV. 77 (2012).

¹³⁰ 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% 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.

¹³¹ See, I.R.C. § 4944, which subjects private foundations to an excise tax of 10% if it invests in a manner that jeopardizes its ability to carry out of its exempt purposes.

¹³² Princeton University, Report of the Treasurer 2016–2017 at 16 (2017).

¹³³ I.R.C. § 4940. The tax rate can be reduced from 2% to 1%.

¹³⁴ Akash Deep and Peter Frumkin found that the level of distributions from foundations clustered around 5% and there was little consideration by program officers about whether a higher level might be appropriate. See *The Foundation Payout Puzzle* (Hauser Ctr. for Non-profit Org., Working Paper 9, 2005), <http://ssrn.com/abstract=01826.o>.

2. Reducing Tuition

Tuition is a major revenue source based on the costs of providing 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.¹³⁵ They have also eliminated or reduced the loan component of the aid package.¹³⁶ Where the large endowment schools have fallen down is they increased neither the size of their student bodies by much, nor the percentage of underrepresented constituencies.¹³⁷ Congress never understood the tuition issue, and the statute ignores it.

3. 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.¹³⁸

¹³⁵ Melissa Korn, *Princeton, Others Aim to Accept More Low-Income Students*, WALL ST. J. (March 1, 2018, 9:04 AM), <https://www.wsj.com/articles/princeton-others-aim-to-accept-more-low-income-students-1519900203>.

¹³⁶ 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 Harvard College, *How Aid Works*, <https://college.harvard.edu/financial-aid/how-aid-works>.

¹³⁷ Schlunk, *supra* note 96, at 736–37. See also, Chaker, *supra* note 55. *Some Colleges Cut, Eliminate Student Debt — Soaring Tuition, Pressure to Spend Endowments Spur Schools to Offer More Grants*, WALL ST. J., Nov. 29, 2007, <https://www.wsj.com/articles/SB119630622387507526>.

¹³⁸ Letter to Senator Roy D. Blunt (Nov. 5, 2017), <https://source.wustl.edu/wp-content/uploads/2017/11/The-Honorable-Roy-D.-Blunt.pdf>.

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, thus 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 income of students' families is \$29,000. Berea's \$1.150 billion endowment averages \$692,571 per student.¹³⁹

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. One of its senators, Mitch McConnell (R-KY) is the majority leader.¹⁴⁰

¹³⁹ 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 \$3,000 difference between the \$35,000 paid by the endowment and tuition's true cost.

¹⁴⁰ 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 (2018), so that any college with fewer than 500 "*tuition-paying*" students and an endowment-per-student ratio 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 Zelinsky disagrees with the Berea exemption, which was granted in Senator McConnell's words "for doing

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. Cooper Union had no tuition for over 100 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 to the administration, the trustees agreed to attempt a return to the free tuition policy. The excise tax makes that goal more difficult.¹⁴¹

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?¹⁴²

good things with its endowment." Professor Zelinsky 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. Zelinsky, *supra* note 87, at 142.

¹⁴¹ See Charles V. Bagli, *State Reaches a Deal to End Litigation at Cooper Union*, N.Y. TIMES, Sept. 2, 2015, at A19.

¹⁴² 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, on 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.

4. Exemptions from the Tax of Certain Large Endowment Schools

The statute is under-inclusive in that some huge endowments are exempt because they have large student populations. Among the schools and endowments that are exempt from the excise tax 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 the 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.¹⁴³

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.¹⁴⁴

B. *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 trigger, as it 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 variable. The legislation recognizes none of this.

Bipartisan legislation to repeal the endowment investment income tax, the "Don't Tax Higher Education Act," sponsored by John Delaney (D-MD) and Bradley Byrne (R-AL), was introduced but died when Congress adjourned before it was voted upon.¹⁴⁵

¹⁴³ *Id.*

¹⁴⁴ Professor Zelinsky proposes a single tax rate or single rate schedule should apply to the net investment incomes of all charitable endowments. See Zelinsky, *supra* note 87.

¹⁴⁵ Adam Harris, *A Tax on Endowments Became Law. But Congressmen and Colleges Are Still Fighting It*, CHRON. HIGHER ED., March 8, 2018, 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.

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.

A. *State and Local Erosion of Tax-Exempt Status*

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.¹⁴⁶ 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.¹⁴⁷ Both bills were defeated.¹⁴⁸

B. *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, and Gabriel Zucman shows the increasing

¹⁴⁶ Adam H. Langley et al., *Payments in Lieu of Taxes by Nonprofits*, LINCOLN INST. OF LAND POL’Y, Sept. 2012, <https://www.lincolninst.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% 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.”).

¹⁴⁷ *Id.*

¹⁴⁸ Schlunk, *supra* note 96, at 702. 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 Connecticut Mulls Endowment Tax, Florida Invites Yale to Relocate*, CHRON. PHILANTHROPY, Apr. 5, 2016, 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.

wealth of the upper 1% of pre-tax income compared to the stagnation of the bottom 50%.¹⁴⁹ The endowment elite of colleges and universities mirror their results. Their growing 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 both 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 very few institutions.¹⁵⁰ The concentration of wealth in the largest educational endowments is staggering.

¹⁴⁹ See Thomas Piketty et al., *Distributional National Accounts: Methods and Estimates for the United States* (WASHINGTON CENTER FOR EQUITABLE GROWTH, Working Paper 2016–2012, Dec. 6, 2016), <http://equitablegrowth.org/working-papers/distributional-national-accounts/>. Their study found the average pretax earnings of an American in the bottom 50% by income was \$16,197 in 2014, a nearly invisible 2.6% gain over 40 years. However, over the same period, the top 10% of Americans saw their pretax incomes grow by 231%. 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% of earners took home 10.5% of the total national income, and the bottom half earned 20% of it. By 2014, those percentages effectively flipped, with the top 1% earning a 20% share and the bottom half dropping to 12.5%.

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% 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% of the American work force, but only one in 10 of the top 0.1% 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% 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.

¹⁵⁰ 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." JONATHAN R. COLE, *THE GREAT AMERICAN UNIVERSITY* 474–76 (2009).

TABLE 5
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.¹⁵¹
- Harvard and Yale's combined endowments as a percentage of the endowments of the top ten schools in endowment assets = 32.1%¹⁵²
- The top five schools' combined endowment assets as a percentage of the endowments of the 809 Institutions = 24.4%¹⁵³
- The top ten schools' combined endowments as a percentage of the endowments of the 809 Institutions = 34.7%¹⁵⁴

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.¹⁵⁵ 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.¹⁵⁶ These institutions are prodigious fundraisers that provide current funds and other sources of increases to their endowments.¹⁵⁷ They

¹⁵¹ Harvard and Yale's Combined Endowments = \$36.02 Billion + \$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. 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%.

¹⁵² Harvard and Yale's Combined Endowments/Total Endowment Value of the Top Ten Schools' Endowments = \$63.197 Billion/\$196,851,563 Billion = 32.1%. *Id.*

¹⁵³ Top 5 endowments combined = \$138,329,895 Billion/\$566.8 Billion = 24.4% of all endowments. *Id.*

¹⁵⁴ Top 10 endowments combined = \$196,851,563 Billion/\$566.8 Billion = 34.7% of all endowments. *Id.*

¹⁵⁵ Halperin, *supra* note 80, at 21.

¹⁵⁶ Charles T. Clotfelter, *How Rich Universities Get Richer*, CHRON. HIGHER EDUC. REV., Oct. 27, 2017, <https://www.chronicle.com/article/How-Rich-Universities-Get/241567>.

¹⁵⁷ See Michael McDonald et al., *Harvard Billionaires Bail Out Alma Mater From Poor Fund Returns*, BLOOMBERG, June 26, 2018, <https://www.bloomberg.com/news/articles/2018-06-26/harvard-billionaires-bail-out-alma-mater-from-poor-fund-returns>. In the 2017–2018 fiscal year, U.S. colleges and universities received \$46.7 billion in gifts, headed by Harvard University's \$1.42 billion. The total, the largest amount ever, was fueled by stock market gains

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 1999–2013.¹⁵⁸ Among their findings was that 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.¹⁵⁹ 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%).¹⁶⁰ Only 3.8% of students come from the bottom quintile of the income distribution at Ivy-Plus colleges.¹⁶¹

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.¹⁶² 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 2011.¹⁶³ 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 increase significantly.¹⁶⁴ These figures bolster an argument that elite schools' endow-

and timed to evade the changes in tax laws. The top ten recipients of donations raised 18% of all funds in a survey of 929 institutions conducted by the Council for the Advancement and Support of Education. See Melissa Korn, *Giving to Colleges Hits \$46.7 Billion*, WALL ST. J., Feb. 11, 2019, <http://www.wsj.com/articles/giving-to-colleges-jumps-7-2-to-record-46-7-billion-11549861260>.

¹⁵⁸ See presentation of Raj Chetty, John N. Friedman, Emmanuel Saez, Nicholas Turner, & Danny Yagan, *Mobility Report Cards: The Role of Colleges in Intergenerational Mobility* (July 2017), http://www.equality-of-opportunity.org/assets/documents/coll_mrc_slides.pdf.

¹⁵⁹ *Id.* at 18.

¹⁶⁰ *Id.* at 14–16.

¹⁶¹ *Id.* at 18.

¹⁶² *Mobility Report Cards: The Role of Colleges in Intergenerational Mobility*, (HCEO Working Paper Series 2017-059; July 2017), http://humcap.uchicago.edu/RePEc/hka/wpaper/Chetty_Friedman_Saez_et_al_2017_mobility-report-cards.pdf.

¹⁶³ *Id.* at 3, 14.

¹⁶⁴ *Id.*

ments should be used more for current spending to alleviate this lack of access for poorer constituencies in our society.

C. *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.¹⁶⁵ 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.

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. 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.¹⁶⁶ 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.¹⁶⁷ 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 future by the largest endowments. The need for more spending to provide financial assistance for underrepresented constituencies is now.

VI. PROPOSALS FOR CHANGE

A. *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 en-

¹⁶⁵ Halperin, *supra* note 80, at 310.

¹⁶⁶ Zelinsky, *supra* note 88.

¹⁶⁷ Note that Harvard spends but 3% or \$178 million of its \$5.9 billion operating budget on financial aid for undergraduate and graduate students.

dowment 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 through 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.¹⁶⁸ In recent decades public universities have had their state support restricted to the extent that many can no longer compete with elite private schools. It may 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.¹⁶⁹

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).¹⁷⁰

¹⁶⁸ 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. The violation, opposition argued, was because the exemption compelled States to issue bonds in registered form, or the exemption 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.

¹⁶⁹ In 2016–2017, 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 strategic budget process and negotiation with the State is dedicated to the levels and use of these core fund sources." 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. The total strategic budget process was \$7.8 billion. "State General Fund support for UC provide[d] \$3.13 billion in 2016–2017, including \$3.04 billion of critical permanent base support for the University's core mission activities." University of California, Budget for Current Operations 2017–2018, 47 (Jan. 2017) available at <http://regents.universityofcalifornia.edu/regmeet/jan17/b1attach2.pdf>.

¹⁷⁰ 2017 NCSE, *supra* note 37.

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.¹⁷¹

B. *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. Children of wealthy individuals or families receive not so secret preferences, as do some children of celebrities and politicians.¹⁷² Even at the most elite institutions, athletes are recruited and make up a disproportionate percentage of the diversity constituency.¹⁷³

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

¹⁷¹ A third cohort is private secondary schools with endowments of one billion dollars or more. There are three: Hershey School (\$12.5 billion), the Kamehaneha School (\$11.1 billion), and Phillips Exeter (\$1.1 billion). They should be liable for the tax and be able to reduce the tax’s impact.

¹⁷² See Daniel Golden, *The Story Behind Jared Kushner’s Curious Acceptance into Harvard*, PROPUBLICA, Nov. 18, 2016, <https://www.dailykos.com/stories/2016/11/21/1602630/-The-Story-Behind-Jared-Kushner-s-urious-Acceptance-into-Harvard>. Daniel J. Kenny, *The Myth of Meritocratic Admissions at Harvard*, THE CRIMSON, Aug. 8, 2017, <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*, THE CRIMSON, <http://features.thecrimson.com/2017/freshman-survey/makeup-narrative>. The seemingly subjective nature of admission is suggested by Anemona Hartocollis et al., *Z-Lists, and Other Secrets of Harvard Admission*, N.Y. TIMES, July 30, 2018, at A1.

¹⁷³ Saahil Desai, *College Sports Are Affirmative Action for Rich White Students*, THE ATLANTIC, Oct. 23, 2018, <https://www.theatlantic.com/education/archive/2018/10/college-sports-benefits-white-students/573688/> (“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%. Yet the admit rate for nonathletes with the same score was 0.076%—nearly 1,000 times lower. Similarly, 83% of athletes with a top academic score got an acceptance letter, compared with 16% 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% boost in admissions, compared with 25% for legacies and 18% for racial minorities.”).

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.¹⁷⁴

C. 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 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.

D. 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, are already 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 stu-

¹⁷⁴ 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.

dents.¹⁷⁵ 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-generation college students by 62% in the past five years. In that same period, the number of incoming students receiving Pell grants has grown by 61%.¹⁷⁶

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 of-

¹⁷⁵ See Melissa Korn, *Colleges Push to Enroll Low-Income Students*, WALL ST. J., March 2, 2018, at A3. See also, Amanda Gordon, *Princeton Gets \$65 Million From the Perelmans to Add Undergrads*, BLOOMBERG, Dec. 5, 2018, <https://www.bloomberg.com/news/articles/2018-12-05/perelmans-give-princeton-65-million-to-fund-residential-college?elqTrackId=b26d541f9524ab9b97daf706a9c40a2&elq=97ed2a0873f04dc4bc4130a261b1b7a7&elqaid=21598&elqat=1&elqCampaignId=10390>.

¹⁷⁶ 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), <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% of their students in six years.

ferred 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.

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.