

TAXING AND REGULATING COLLEGE AND UNIVERSITY ENDOWMENT INCOME: THE LITERATURE'S PERSPECTIVE

Mark J. Cowan^{*}

ABSTRACT

College and university endowments have reported outstanding investment returns in recent years. While annual investment returns have averaged around 15.2%, colleges and universities have only been spending about 4.6% of their endowment assets each year. This has drawn the attention of the Senate Committee on Finance, which recently held a hearing regarding the accumulation of endowment income at colleges and universities and debated whether endowments should be taxed or regulated (for example, by the use of the minimum distribution requirement that applies to private foundations). This Article marshals and fuses the existing literature on endowments, the rationales for tax exemptions, the justifications for the unrelated business income tax, and the reasoning behind the private foundation minimum distribution requirements to determine whether a tax on endowment income or a minimum distribution requirement would be consistent with our current understanding of how colleges and universities should be taxed. The Article concludes that the existing literature would not justify taxing or regulating endowment accumulation and that any attempt to tax or regulate endowments should only be undertaken in light of a fundamental re-imagining of our tax exempt system.

^{*} Assistant Professor, Boise State University. J.D., University of Connecticut (2004); M.S.T., University of Hartford (1996); B.S., University of Connecticut (1991), CPA. This Article will be presented at the Legal Research Session of the American Taxation Association's Mid-Year Meeting in Memphis, Tennessee in February, 2008. I thank the anonymous reviewers for the Legal Research Session for their helpful comments and suggestions. I also thank Bill Ilett of the Boise State University Foundation for his helpful information and Jacob Zwygart for his research assistance.

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“The trustees of an endowed institution are the guardians of the future against the claims of the present.”¹

I. INTRODUCTION

College and university endowments have experienced tremendous growth in recent years. For the fiscal year ended in June of 2006, 765 institutions reported a combined \$340 billion in endowment assets.² These assets generated earnings of 15.3%, or \$52 billion.³ This income is, in general, not subject to the federal income tax.⁴ By not taxing this income, the federal government forgoes annual revenue of about \$18 billion.⁵ This figure dwarfs the estimated \$6.6 billion annual revenue loss from the deduction for charitable contributions to educational institutions.⁶

While endowment earnings have increased to around 15.3%, payout rates (the percentage of the endowment spent each year) have remained steady at about 4.6%.⁷ At

¹ James Tobin, *What is Permanent Endowment Income?*, 64 AM. ECON. REV. 427, 427 (1974).

² Jane G. Gravelle, Cong. Research Serv., *Tax Issues and University Endowments 1* (Aug. 20, 2007) [hereinafter CRS Memo] (memorandum to Max Baucus and Chuck Grassley of the Senate Committee on Finance) available at <http://www.senate.gov/~finance/hearings/testimony/2007test/092607testjg.pdf>.

³ *Id.* See *infra* Part III for a discussion of how the endowments managed such impressive returns. For a database of endowment market values, see <http://chronicle.com/stats/endowments/> (subscription to the *Chronicle of Higher Education* may be required).

⁴ See *infra* Part II.

⁵ CRS Memo, *supra* note 2, at 3. This assumes the income would be taxed at the normal corporate income tax rates.

⁶ See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures For Fiscal Years 2007-2011* 32 (JCS-3-07, Sept. 24, 2007) available at <http://www.house.gov/jct/s-3-07.pdf>. The \$6.6 billion is the projection for 2007, and includes lost revenue from corporate taxpayers of \$.7 billion and from individual taxpayers of \$.9 billion. See *id.* For the period 2007-11, the projected total revenue loss from the deduction for charitable contributions to educational institutions is estimated to be \$36.8 billion. *Id.* Presumably this estimate includes gifts to educational institutions at all levels (not just gifts to colleges and universities).

⁷ CRS Memo, *supra* note 2, at 2. A recent survey indicates that fiscal 2007 average returns have increased to 17.2% while payout rates have remained steady at about 4.6%. See Goldie Blumenstyk, *Colleges Saw Endowment Gains of 17.2% Last Year but Don't Expect a Repeat*, CHRON. HIGHER ED., Jan. 24, 2008. This Article uses the fiscal 2006 figures since it was the fiscal 2006 figures that were debated in the Senate Committee on Finance. See *infra* note 10. In any case, the fiscal 2007 estimates indicate the same issue as the fiscal 2006 amounts—a wide gap between endowment earnings and payouts. As of this writing,

the same time, tuition rates have increased.⁸ In light of these numbers, some have called on colleges and universities to stop “hoarding” their endowment income and to begin using the funds to increase student aid and limit tuition increases.⁹ The Senate Committee on Finance has taken note of this issue, and held a hearing on September 26, 2007 to consider testimony as to whether endowment funds should be taxed or be subject to minimum distribution requirements.¹⁰ In January of 2008, Senators Baucus and

college and university officials are predicting that endowment returns will decline in fiscal 2008 because of a downturn in the economy and increased market volatility. *See* Blumenstyk, *supra*.

⁸ CRS Memo, *supra* note 2, at 2; *see also Tuition Increases Outpace Financial Aid*, WALL ST. J., Oct. 23, 2007, at D4 (reporting an average 6.6% increase in tuition for public institutions and an average 6.3% increase in tuition for private institutions in the 2007-08 school year).

⁹ *See, e.g.*, Offshore Tax Issues, Reinsurance and Hedge Funds: Hearings Before the S. Comm. on Fin., Sept. 26, 2007 (testimony of Lynne Munson, Adjunct Fellow, Center for College Affordability and Productivity) [hereinafter Munson Testimony] *available at* <http://www.senate.gov/~finance/hearings/testimony/2007test/092607testlm.pdf>.

¹⁰ Prepared testimony and a video of the hearing are *available at* <http://www.senate.gov/~finance/sitepages/hearings.htm>. The September 26, 2007 hearing was billed as a discussion of offshore tax issues involving hedge funds and reinsurance companies. In addition to these topics, however, two witnesses testified regarding college and university endowments and whether such endowments should be subject to minimum distribution requirements. *See id.*; CRS Memo, *supra* note 2 (testimony of Jane G. Gravelle, Congressional Research Service); Munson Testimony, *supra* note 9. While the focus of the testimony was on possible mandated payout percentages, the issue of taxing endowment income was also raised. *See* Andy Guess, *Senate Scrutiny for Endowments*, INSIDE HIGHER ED, Sept. 27, 2007 at <http://www.insidehighered.com/news/2007/09/27/endowments>. A third witness discussed the use of hedge fund investments by endowments. Offshore Tax Issues, Reinsurance and Hedge Funds: Hearings Before the S. Comm. on Fin., Sept. 26, 2007 (testimony of Suzanne Ross McDowell, Steptoe & Johnson LLP) [hereinafter McDowell Testimony] *available at* <http://www.senate.gov/~finance/hearings/testimony/2007test/092607testsm.pdf>. This issue is discussed at *infra* Part II.C.2. No representatives of college and university endowments were invited to the hearing, but a group representing such interests did subsequently submit written testimony disputing the claims made at the hearing. Offshore Tax Issues, Reinsurance and Hedge Funds: Hearings Before the S. Comm. on Fin., Sept. 26, 2007 (testimony for the record submitted by the American Council on Education, the Association of American Universities, the National Association of Independent Colleges and Universities, and the National Association of State Universities and Land-Grant Colleges on Oct. 10, 2007) [hereinafter Higher Education Associations Testimony] *available at* http://www.aau.edu/issues/Test_Assn_Univ_Endow_10-10-2007.pdf.

The hearing on endowment practices was but one of the shots that Congressional tax-writing committees have fired across the bow of the higher education community in recent years. In October of 2006, Bill Thomas, then the Chairman of the House Committee on Ways and Means, sent a letter to the National Collegiate Athletic Association (NCAA) questioning the organization’s tax exempt status. Meg Shreve, *Thomas Takes on NCAA’s Tax-Exempt Status*, TAX NOTES TODAY, Oct. 5, 2006, at 193-2 (the cited article includes a link to the text of Thomas’s letter). The letter focused on whether the NCAA’s activities regarding intercollegiate athletics were truly “educational” in light of the millions of dollars in revenue being generated by college football and basketball. *Id.* The NCAA responded to the Thomas inquiry with a 25 page letter (plus two appendices) arguing that the NCAA was continuing to advance education. Letter from Myles Brand to William Thomas (Nov. 13, 2006), *available at*

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Grassley followed up on the September hearing and sent letters to 136 colleges and universities with endowments of \$500 million or more.¹¹ The letters requested detailed information on endowment investment, endowment payout, tuition, and financial aid policies.¹²

The question of whether to tax and/or regulate endowment income is controversial and implicates important issues of tax policy and institutional governance. The possibility of a tax or regulation is likely to engender entrenched positions on the part of endowed colleges and universities on the one hand, and education advocates and policymakers concerned about rising tuition costs on the other.¹³ The purpose of this Article is to move beyond the rhetoric and analyze the endowment issue in light of the literature on the optimal use of endowments, the rationales for granting educational institutions tax exempt status, the rationales underlying the unrelated business income tax (UBIT), and the rationales for the minimum distribution requirements currently imposed on private foundations. In short, this Article marshals and fuses the existing literature to

http://www2.ncaa.org/portal/media_and_events/press_room/2006/november/20061115_response_to_house_committeeonwaysandmeans.pdf. To date nothing further had occurred on this front.

In May of 2007, the Senate Committee on Finance considered several provisions that would affect colleges and universities, including taxing tuition benefits for children of college and university employees, and subjecting some hedge fund income to the unrelated business income tax (which will be discussed further at *infra* Part II.C.2). Elizabeth Redden & Doug Lederman, *Muddled Tax Picture for Higher Ed*, INSIDE HIGHER ED, May 23, 2007, at <http://www.insidehighered.com/news/2007/05/23/tax>. The Senate Committee on Finance also considered minimum distribution requirements for endowments at that time. *Id.* To date, the Committee's activity has not resulted in new legislation.

Most recently, in October of 2007, Senate Committee on Finance Ranking Member Charles Grassley announced that he would be looking into the tax status of nonprofit organizations that support college athletic departments. Brad Wolverton, *Key Senator to Question Tax Treatment of Booster Clubs*, CHRON. HIGHER ED., Oct. 5, 2007, at A34. Grassley was responding to reports that athletic programs were getting a larger share of the donations that go to colleges and universities and that athletic donors were receiving perks such as free seats on flights chartered by collegiate sports teams. *Id.*

¹¹ *Baucus, Grassley Question Colleges on Endowments, Tax Benefits*, TAX NOTES TODAY, Jan. 24, 2008, at 17-38.

¹² *Id.* Responses are due from the colleges and universities within 30 days. *Id.*

¹³ *See, e.g., J.J. Hermes, Senators Weigh Idea of Requiring Payout Rates for Large University Endowments*, CHRON. HIGHER EDUC., Sept. 27, 2007 (quoting representatives of groups for and against regulation/taxation of college and university endowments); see also the testimony cited in *supra* note 10.

determine whether a tax on endowment income or a minimum distribution requirement would be consistent with our current understanding of how colleges and universities should be taxed.

As of this writing, there are no specific proposals before Congress to change the way colleges and universities are taxed on their endowment income. Based on the testimony and discussion surrounding the hearings before the Senate Committee on Finance, however, this Article considers two possible changes: 1) subjecting endowment income to the corporate income tax via the unrelated business income tax and 2) mandating a minimum distribution requirement modeled on the current minimum distribution requirements for private foundations.¹⁴ Further, this Article assumes any changes would apply to both private and public colleges and universities.¹⁵

This Article proceeds as follows. Part II summarizes the current tax treatment of colleges and universities, including the tax rules governing investment income from endowments. Part III then discusses endowments, the purposes they serve in higher education, and arguments for and against accumulation of endowment income. Part IV

¹⁴ See *supra* note 10. Variations of these two ideas were discussed at the September 26, 2007 hearing. For example, perhaps a tax would only be applied if tuition were increased by a certain amount. Also, perhaps the tax or minimum distribution requirement would only apply to endowments of a certain size. To some extent the tax and minimum distribution changes overlap—in that the payout requirement would be enforced via an excise tax on undistributed income. See *infra* Part VI.A. for the mechanics of the minimum distribution rules. Bear in mind that any proposal that actually materializes may be more complicated than the simple version analyzed here.

Prior to the September 26, 2007 hearing in the Senate Committee on Finance, a tax or minimum distribution requirement on endowments occasionally appeared on lists of revenue-raisers or reform ideas. See, e.g., George Break & Joseph A. Pechman, *Relationship Between Corporation and Individual Income Taxes*, 28 NAT'L TAX J. 341, 344 (1975) (raising the possibility of taxing the investment income of charities if corporate and individual income taxes were integrated); Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 7 (1990) [hereinafter Hansmann, *Endowments*] (describing a 1987 proposal in Congress to apply a 5% excise tax on the endowment investment income on all tax-exempt organizations, including colleges and universities); Martin Sullivan, *Revenue Raising Ideas for the Next Tax Bill*, TAX NOTES, Dec. 10, 2001, at 1363, 1364 (suggesting Congress consider taxing the income earned by large university endowments). See also *infra* note 312 for prior minimum distribution proposals.

¹⁵ See *infra* notes 18-20 and accompanying text, noting that the issues surrounding endowments are generally the same for both public and private institutions.

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reviews the rationales that commentators have developed to explain why nonprofits, including colleges and universities, are granted tax exempt status. Part IV then reviews whether a tax on endowment income would be consistent with those rationales. Part V reviews the rationales that commentators have used to justify the unrelated business income tax (UBIT), which is applied to certain commercial ventures of tax exempt organizations, and considers whether the extension of UBIT to endowment income would be consistent with those rationales. Part VI reviews the rationales behind the more onerous rules that apply to tax exempt entities classified as private foundations. Part VI then compares private foundations to colleges and universities to determine if the private foundation minimum distribution requirements should be extended to endowments. Part VII concludes that, taking all of the literature into account, taxation or regulation of endowments would not be justified based on our current understanding of how colleges and universities should be taxed.

II. CURRENT TAXATION OF COLLEGES AND UNIVERSITIES

A. The Private/Public Distinction

A private, nonprofit college or university, because it exists for educational purposes, is eligible for exemption from the federal income tax as a section 501(c)(3) organization.¹⁶ A public college or university is exempt from the federal income tax by virtue of being part of the state government.¹⁷ The private/public distinction, however, is

¹⁶ While I.R.C. § 501(c)(3) defines what types of organizations are eligible for the exemption, it is I.R.C. § 501(a) that actually grants the exemption.

¹⁷ At first glance, it appears that I.R.C. § 115 covers the tax treatment of state governments. § 115(1) states that “[g]ross income does not include income derived from a public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof” Thus, per § 115, it appears that income from the commercial enterprises of state governments (which would not be considered

not particularly critical when analyzing whether endowment income should be taxed or regulated.¹⁸ First, despite the private/public difference in the source of the underlying tax exemption, both private and public institutions are subject to UBIT in the same manner.¹⁹ Second, endowments of public universities are normally not held by the state institutions themselves. Rather, endowments are raised, managed, and distributed by “supporting organizations” that independently qualify for tax exemption as section 501(c)(3) organizations.²⁰ Accordingly, many of the policy issues implicated by endowments are

an “essential governmental function”) would be subject to the federal income tax while income from governmental functions would be exempt. The IRS, however, has interpreted the “accruing to” language in § 115 as meaning that the commercial/governmental distinction only applies to entities owned by state governments. *See* Gen. Couns. Mem. 14,407, 1935-1 C.B. 103 (Jan. 23, 1935). State governments themselves are not subject to § 115. *Id.* Rather, the IRS views state governments as simply falling outside the scope of the Internal Revenue Code. *Id.* Under the IRS’s view, *all* income of a state government, commercial or governmental, is exempt from the federal income tax. *See id.* While the rationale for this stance is unclear, the IRS’s approach at least has the virtue of avoiding the difficult task of distinguishing between the commercial and governmental functions of the state government.

Although the IRS views states (including state colleges and universities) as generally beyond the reach of the I.R.C., there is one code provision that specifically subjects some income of states to the federal income tax. I.R.C. § 511(a)(2)(B) applies the unrelated business income tax (UBIT) to state colleges and universities. *See infra* Part II.C. for further discussion.

¹⁸ The private/public distinction is, of course, relevant for nontax legal reasons. For example, a public institution owes due process and other constitutional protections to students, faculty, and staff while private institutions generally do not. *E.g.* WILLIAM A. KAPLIN & BARBARA A. LEE, *THE LAW OF HIGHER EDUCATION* 42 (4th ed. 2006). The line dividing public and private institutions is not always clear. *See id.* at 42-43. Since the private/public distinction is not particularly important in analyzing endowments, this issue is not discussed further. For more details, *see id.* at 42-54.

¹⁹ *See infra* Part II.C. Any extension of the UBIT regime to cover endowment income would, therefore, presumably apply to both private and public institutions.

²⁰ The structure used by the University of Idaho, for example, is typical. The school’s endowment is owned and managed by a separate entity, the University of Idaho Foundation, Inc., for the exclusive benefit of the University of Idaho. *See* <http://www.uidahofoundation.org>. The foundation handles fundraising for the University of Idaho, and all decisions regarding fundraising priorities are set by the administration of the university itself. *See* Frequently Asked Questions, at <http://www.uidahofoundation.org/default.aspx?pid=84514>. The foundation’s website explains the use of a separate fundraising and endowment organization as follows:

Why is the [University of Idaho] Foundation separate from the University of Idaho? The vast majority of American public colleges and universities have separate Foundations, organized as not-for-profit 501 (c) (3) corporations, for good reasons: confidentiality of personal documents related to gifts such as wills, trust agreements and correspondence; stewardship of endowment funds to ensure the joint goals of growth and return are met in the best interest of the donors; and to provide flexibility through discretionary funds to the growth of programs of excellence at the University of Idaho.

Id. The last point, regarding “flexibility regarding discretionary funds” is critical. Public colleges and universities use separate foundations in order to raise private money that they can use outside of the confines of state-imposed restrictions on expenditures. *E.g.*, BRUCE M. STAVE, *RED BRICK IN THE LAND OF*

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the same for both public and private institutions.²¹ For the remainder of this Article, therefore, the private/public distinction is only noted where relevant.

In addition to being exempt from the federal income tax, colleges and universities are exempt from the accumulated earnings tax.²² The accumulated earnings tax is a surcharge on the income a corporation has not distributed and which is not needed to support the reasonable needs of the business.²³ The tax is designed to prevent corporations from postponing the distribution of income to shareholders and the

STEADY HABITS: CREATING THE UNIVERSITY OF CONNECTICUT, 1881-2006 112-13 (2006) (reporting that the University of Connecticut established a foundation in the 1960s to create a pool of funds the school could use, without state restrictions, to help the school achieve excellence). Many schools have more than one supporting foundation. For example, a school may have, in addition to its general supporting foundation, an athletic booster club that raises and invests money to support the school's athletics programs. *E.g.*, Paul Fain, *Oregon Debates Role of Big Sport Donors*, CHRON. HIGHER ED., Oct. 26, 2007, at A38 (indicating how donations raised by booster clubs are used in college and university athletic departments). Provided the supporting foundation receives enough public support, it will not be considered a private foundation. I.R.C. § 509(a)(1). See further discussion at *infra* Part VI.A.

Large public college and university-related endowments are, in many cases, a relatively recent phenomena, rendered necessary by decreased state funding. See *infra* note 323. For example, the University of Connecticut Foundation was established in 1964 and so far has undertaken two major capital campaigns. See About the UConn Foundation, at <http://www.foundation.uconn.edu/basepage.asp?page=0044>. In contrast, many private universities, such as Yale, have had significant endowments for centuries. See, *e.g.*, THE YALE ENDOWMENT: 2006 16, 22-24, available at <http://www.yale.edu/investments> (providing a history of prominent gifts to Yale's endowment going back to the 1800s); Hansmann, *Endowments*, *supra* note 14, at 21 (indicating that "universities such as Harvard and Yale began accumulating substantial endowments by the middle of the nineteenth century").

²¹ An anonymous reviewer of a draft version of this Article identified a possible public/private distinction that is worthy of note. Specifically, the reviewer suggested there may be a stronger case for imposing a minimum distribution requirement on endowments of *public* institutions because many public institutions, unlike private institutions, rely on state funds (rather than their endowment) to cover basic operating costs. Presumably, this means public institutions can better afford to accumulate their endowment earnings. This argument may be worth exploring further in another venue, but this Article does not do so. First, the line between public and private institutions has become increasingly blurred. As noted at *supra* note 20 and *infra* note 323, state support for higher education has been declining. This reality is forcing state institutions, like their private brethren, to raise private money to fund more of their ongoing operations. Second, if a state institution were using state funds for daily operations and unwisely accumulating its endowment, presumably the state government could pressure the public college or university to spend more of its endowment—or face possible cuts in funding. See also *infra* note 318. Third, state governments may well take offense at having their institutions subjected to more federal regulation than private (and perhaps wealthier) institutions—which could raise thorny political (as well as perhaps constitutional) issues.

²² I.R.C. § 532(b)(2).

²³ I.R.C. §§ 531 (imposing the accumulated earnings tax); 537(a) (elaborating on the "reasonable needs of the business").

shareholder level tax that would apply.²⁴ Unlike for-profit enterprises, colleges and universities may accumulate non-operating investments (such as endowments) free from the specter of the Internal Revenue Code.²⁵

B. Basic Requirements for Tax Exemption Under Section 501(c)(3)

To qualify as a section 501(c)(3) organization, a nonprofit must be:

organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, . . . and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.²⁶

This definition, as it applies specifically to institutions of higher education, is dissected in the sections which follow.

1. The Educational Mission in the Organizational and Operational Tests

In order to attain and maintain tax exempt status, the nonprofit must be “organized and operated exclusively” for one of the enumerated purposes listed in section

²⁴ See I.R.C. § 532(a).

²⁵ One commentator has suggested that, if the exclusion for nonprofits from the accumulated earnings tax were repealed, there would be a “serious question” over whether endowments would be taxed. Hansmann, *Endowments*, *supra* note 14, at 7 n.15. Given that the tax was designed to ensure the shareholder level tax on corporate income was not unreasonably deferred, it is unclear how the tax would be imported into the nonprofit world. Nonprofits are subject to the non-distribution constraint and thus are prohibited from distributing their income to, for example, shareholders, founders, members, or insiders. See *infra* Part II.B.2. If the institution does not distribute the endowment earnings, they are not necessarily engaged in tax avoidance. If the earnings were distributed in the form of student aid, this presumably would not create any taxable income to the recipient. As such, the purpose of the accumulated earnings tax would not be applicable in such a case. Alternatively, if the earnings were spent on higher faculty or staff salaries, they would generate additional income to the employees receiving such salaries. In any case, what is clear is that the accumulated earnings tax concept would not be easily imported into the realm of tax-exempt nonprofits.

²⁶ I.R.C. § 501(c)(3).

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501(c)(3).²⁷ For colleges and universities, the enumerated purpose is, of course, education.²⁸ The “educational” purpose is listed separately from the more generic “charitable” purpose in section 501(c)(3). Accordingly, colleges and universities are worthy of tax exemption because they help society through education, not because they are of immediate help to the less fortunate.²⁹ There is no requirement for a college or university to prove that it is engaged in “charitable” works.³⁰ In fact, some commentators have speculated that a school, so long as it is providing education, can retain its tax exemption even if it charges high prices for its services and does not provide any financial aid to students.³¹ Since the exemption is granted based on providing

²⁷ Inherent in this requirement is an organizational test and an operational test. The organizational test requires that the nonprofit’s organizational documents limit the entity’s activities to tax exempt purposes, prohibit the entity from engaging in any substantial nonexempt activities, and provide that, upon dissolution, the assets of the entity will be distributed to another nonprofit charitable organization or the government. Treas. Reg. § 1.501(c)(3)-1(b). The operational test requires that the nonprofit be operated in accordance with the dictates of the organizational documents—i.e., the entity must operate “exclusively” for a nonprofit purpose. Treas. Reg. § 1.501(c)(3)-1(c). “Exclusively” actually means “primarily.” *Id.* A nonprofit can therefore engage in insubstantial activities that are unrelated to its exempt mission without putting its tax exempt status in jeopardy. Most private college and universities (and the organizations supporting public colleges and universities) easily meet these tests.

²⁸ In some circumstances, whether an organization is “educational” can be unclear. This is particularly true with respect to “controversial” groups expressing a particular viewpoint. *See, e.g.*, Rev. Proc. 86-43, 1986-2 C.B. 729 (articulating a “methodology test” to determine if organizations that express a particular viewpoint are engaged in education). The typical college or university does not pose such classification problems and there is normally little doubt they are engaged in education. Recently, however, some have questioned whether certain activities of colleges and universities, like athletics, should still be considered educational. *See, for example*, the discussion regarding intercollegiate athletics at *supra* note 10.

²⁹ The Congressional Research Service explained the societal benefits of education this way: “Economic theory suggests that education causes positive externalities as the acquisition of knowledge and implementation of research occurs, generating both private benefits for individuals and social benefits for the public at large.” Pamela J. Jackson & Erika Lunder, Congressional Research Service, *Higher Educational Institutions: A Discussion of Organizational Status*, Dec. 1, 2006, reprinted in TAX NOTES TODAY, Dec. 1, 2006, at 234-22.

³⁰ *Id.* (indicating that higher education institutions “are not required by law to operate with a charitable purpose” and are not required to serve students from low-income families in order to maintain their tax exempt status). The same can be said for the “religious” purpose in § 501(c)(3). While many religious organizations (like churches) strive to help the poor, they exist primarily to service their own members. There is no requirement that a church be devoted to helping the poor to maintain its tax exempt status.

³¹ *See, e.g.*, JAMES J. FISHMAN & STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 191 (2d ed. 2006) [hereinafter FISHMAN & SCHWARZ] (posing this fact pattern in a problem); JAMES J. FISHMAN & STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS: CASES

education, rather than giving alms for the poor, a requirement that colleges and universities spend more of their endowment income on items such as student financial aid would represent a sea change in how educational institutions are treated under the tax code.

2. *No Inurement/Intermediate Sanctions*

A nonprofit's tax exempt status can be revoked if any of the organization's net earnings inure to the benefit of private shareholders or individuals.³² This “nondistributional” constraint is the primary distinction between nonprofit and for-profit organizations. Any inurement, regardless of amount, can cause an organization to lose its tax exempt status.³³ Inurement can result when an “insider,” such as one of the organization's managers or executives, receives a salary that exceeds fair market value.³⁴

AND MATERIALS TEACHER'S MANUAL 30-31 (2d ed. 2006) (suggesting the answer to the problem posed in the casebook is that there is no “charity care-like” standard for schools). In contrast, an organization claiming tax exemption under the more generic “charitable” category in section 501(c)(3), such as a hospital, must do more than simply provide care to those willing and able to pay. *See, e.g.*, Rev. Rul. 69-545, 1969-2 C.B. 117 (applying a community benefit standard to determine whether a hospital is exempt from tax). A college or university does not need to pass a community benefit test as a prerequisite for tax exemption. *But see infra* note 331, describing a change in this traditional approach that is taking place in the United Kingdom.

³² I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(2).

³³ *See* I.R.C. § 501(c)(3) (“no part of the net earnings of which inures to the benefit of any private shareholder or individual” (emphasis added)); *Church of Scientology of California v. Comm’r*, 823 F.2d 1310, 1316 (9th Cir. 1987) (where the court, in revoking the tax exempt status of the Church of Scientology on account of inurement, noted that an “organization loses tax exempt status if even a small percentage of income inures to a private individual”).

³⁴ *See* *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1176 (7th Cir. 1999) (stating that inurement generally applies to “an insider of the charity” and a section 501(c)(3) organization “is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, the equivalent of an owner or manager”); *Church of Scientology*, 823 F.2d at 1316 (indicating that “payment of excess salaries will result in a finding of inurement”). While the inurement prohibition is concerned with benefits to insiders, a related, but separate, “private benefit” doctrine can apply when benefits flow from the nonprofit to *outsiders*. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). The private benefit doctrine is only invoked when the benefit flowing to the outsiders is substantial and essentially the organization is primarily benefiting private interests rather than the public or a large class of beneficiaries. *See, e.g.*, *American Campaign Academy v. Comm’r*, 92 T.C. 1053 (1999) (holding that a school that trained political campaign workers was not entitled to tax exemption because it primarily benefited private interests—the Republican Party—since almost all of the school's students went on to work for the Republican Party.) Because the benefits to private interests must be substantial and because colleges and universities serve such a broad class of beneficiaries (students, the public, the community,

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Revocation is a harsh, all-or-nothing penalty, which tends to punish the innocent while leaving those who benefited from the inurement largely unscathed. If a college's tax exemption is revoked because earnings inured to its president via an excess salary, for example, it would be the innocent students, staff, faculty, alumni, donors, and surrounding community that would suffer; not the president who benefited from the inurement or the trustees who approved the excess compensation.³⁵ Recognizing this, Congress in 1996 enacted a special excise tax on excess compensation, called "intermediate sanctions."³⁶ Except in the most egregious cases of inurement, intermediate sanctions will apply in lieu of revocation of the organization's tax exempt status.³⁷

The intermediate sanctions apply to "excess benefits" the nonprofit gives to "disqualified persons." A disqualified person is normally someone in a position to "exercise substantial influence" over the organization, such as a manager, board member, or officer.³⁸ An excess benefit is an economic benefit that the organization gives to a disqualified person that is in excess of the value such person has provided to the organization.³⁹ In short, the intermediate sanctions apply when an influential person at a tax exempt entity is given excess compensation.

etc.), the private benefit doctrine is unlikely to pose a threat to the tax exemption of most colleges and universities.

³⁵ FISHMAN & SCHWARZ, *supra* note 31, at 246.

³⁶ I.R.C. § 4958. Only a brief overview of intermediate sanctions is provided here. For more detail, see Treas. Reg. § § 53.4958-1 through -8.

³⁷ See FISHMAN & SCHWARZ, *supra* note 31, at 246-47.

³⁸ I.R.C. § 4958(f)(1); Treas. Reg. § 53.4958-3.

³⁹ I.R.C. § 4958(c)(1); Treas. Reg. § 53.4958-4.

Stripped of detail, the intermediate sanctions apply a tax on the disqualified person equal to 25% of the excess benefit.⁴⁰ If the excess benefit is not “corrected” (returned to the organization), the disqualified person must pay an additional tax equal to 200% of the excess benefit.⁴¹ The intermediate sanctions also apply to organization managers who participated in the provision of the excess benefit.⁴² The tax on the manager is 10% of the excess benefit,⁴³ capped at \$20,000 for any one excess benefit transaction.⁴⁴ Clearly, these rules seek to punish the persons who receive or approve excess benefits, rather than the organization itself.

While the intermediate sanction rules do not apply to state colleges and universities,⁴⁵ they do generally apply to section 501(c)(3) organizations.⁴⁶ Therefore, the intermediate sanctions rules apply to private colleges and universities and the section 501(c)(3) fundraising organizations that support state colleges and universities. While there has been evidence of excess benefits in higher education in recent years, the intermediate sanction rules act as a check on any tendencies to use accumulated endowment funds to pay excess benefits to administrators.⁴⁷

⁴⁰ I.R.C. § 4958(a)(1).

⁴¹ I.R.C. § 4958(b) & (f)(6).

⁴² I.R.C. § 4958(a)(2).

⁴³ *Id.*

⁴⁴ I.R.C. § 4958(d)(2).

⁴⁵ See Treas. Reg. § 53.4958-2(a)(2)(ii) (indicating that a governmental unit is not an “applicable tax exempt organization” and is thus not subject to the intermediate sanction rules).

⁴⁶ Treas. Reg. § 53.4958-2(a)(1).

⁴⁷ As higher education executive compensation has increased, examples of excess compensation have surfaced. For example, the president of American University was forced to resign in 2005 after he was accused of misusing over \$500,000 in the institution’s funds. FISHMAN & SCHWARZ, *supra* note 31, at 233-34. Intermediate sanctions provide the IRS with a powerful weapon to combat such abuse.

Outside of the higher education context, there is evidence that intermediate sanctions can help reign in abuse at well-endowed institutions. For example, the intermediate sanctions were useful in addressing abuse at the Bishop Estate in Hawaii. See generally SAMUEL P. KING & RANDALL W. ROTH, *BROKEN TRUST: GREED, MISMANAGEMENT & POLITICAL MANIPULATION AT AMERICA’S LARGEST CHARITABLE TRUST* (2006). The Bishop Estate was originally established by the will of Princess Bernice Pauahi Bishop, the last of the Hawaiian royal family. The Princess left her substantial landholdings in Hawaii to a charitable trust (known as the Bishop Estate) to establish the Kamehameha schools. After

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3. Lobbying and Political Campaign Restrictions

Beyond the fundamental prohibition on inurement, there are a couple of other explicit ways in which the tax law regulates nonprofit behavior. First, section 501(c)(3) organizations are limited in their ability to lobby.⁴⁸ Specifically, they cannot engage in substantial lobbying.⁴⁹ The rationale behind the lobbying restriction, which had its antecedents going back to 1919, is “clouded in obscurity.”⁵⁰

Second, section 501(c)(3) organizations cannot “participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”⁵¹ This is an absolute ban; any campaign activity can result in the revocation of tax exemption and the imposition of an excise tax on any political expenditures.⁵² The origin of the campaign restriction, which was first enacted in 1954, is unclear. One theory is that the restriction was enacted at the

Hawaii gained statehood and tourism increased, the landholdings held in the Bishop Estate grew substantially in value. Trustees were appointed in a highly politicized process which resulted in a series of trustees that took excess compensation and abused their duties in running the organization. Because the Bishop Estate ran schools, it was exempt from regulation as a private foundation. (See *infra* Part VI.A for an overview of the private foundation regime.) Accordingly, it was the intermediate sanctions that proved to be the most valuable weapon at the IRS's disposal to address inurement at the Bishop Estate. See KING & ROTH, *supra*, at 209-10 (noting how the Bishop Estate opposed the intermediate sanctions bill).

⁴⁸ I.R.C. § 501(c)(3) (indicating that “no substantial part of the activities of” the organization can be “attempting to influence legislation”).

⁴⁹ Because it is often difficult for an organization to tell when it is approaching the forbidden “substantial” level of lobbying, I.R.C. § 501(h) allows the organization to elect to use a complex quantitative test to determine how much it can spend on lobbying before it puts its tax exemption in jeopardy. The election under § 501(h) may trigger an excise tax on lobbying expenditures. See I.R.C. § 4911. For further details, see Treas. Reg. §§ 1.501(h)-1 through 3 & 56.4911-1 through 7.

⁵⁰ FISHMAN & SCHWARZ, *supra* note 31, at 260.

⁵¹ I.R.C. § 501(c)(3).

⁵² I.R.C. § 4955. The political campaign restriction has been a high profile, controversial subject in recent years. This has been particularly true with regard to churches. See, e.g., *Branch Ministries v. Rossotti*, 211 F.3d 137 (2000) (upholding the revocation of a church's tax exemption for publishing an anti-Clinton advertisement in national newspapers on the eve of the 1992 election); FISHMAN & SCHWARZ, *supra* note 31, at 306-08 (recounting other examples of church involvement in political campaigns). In general, however, political campaign intervention has not been a major issue for colleges and universities.

behest of then-Senator Lyndon B. Johnson.⁵³ Johnson, the story goes, wanted to stop a Texas foundation from providing any further support to one of his political opponents.⁵⁴

Both the lobbying and campaign restrictions are examples of where Congress⁵⁵ has sought to regulate nonprofit behavior without clear, articulated rationales. Accordingly, we should be skeptical of further Congressional regulation of nonprofit activity, such as regulation of endowment practices at colleges and universities.

C. Unrelated Business Income Tax (UBIT)

1. In General

While generally exempt from the federal income tax, section 501(c)(3) organizations, such as private colleges and universities and fundraising organizations that support public colleges and universities, pay the federal corporate tax on net income from certain business activities.⁵⁶ This tax, known as the unrelated business income tax (UBIT), also applies to public colleges and universities, even though such institutions are not generally governed by section 501(c)(3).⁵⁷

⁵³ FISHMAN & SCHWARZ, *supra* note 31, at 261.

⁵⁴ *Id.*

⁵⁵ In addition to Congressional restrictions on nonprofit behavior, there is also a loose “public policy” requirement that is imposed by the courts. The primary authority in this area is *Bob Jones University v. U.S.*, 461 U.S. 574 (1983). Even though I.R.C. § 501(c)(3) has no explicit public policy requirement, the Supreme Court upheld the revocation of Bob Jones University’s tax exemption because the school discriminated on the basis of race. *Id.* at 605. Such discrimination violated a clear public policy and therefore violated common law notions of “charity.” *Id.* at 586. The Court noted that tax exemption can be revoked on public policy grounds “only where there can be no doubt that the activity involved is contrary to a fundamental public policy.” *Id.* at 592. It is unclear how far the public policy restriction extends beyond racial discrimination in education. It is fairly safe to say, however, that typical endowment practices at colleges and universities (assuming no racial discrimination is involved) should not invoke the public policy doctrine.

⁵⁶ I.R.C. § 511 (imposing the tax); § 512 (defining the income that will be taxed); § 513 (defining an “unrelated trade or business”).

⁵⁷ I.R.C. § 511(a)(2)(B).

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UBIT applies to income a nonprofit earns from a trade or business that is regularly carried on, and which is unrelated to the nonprofit's tax exempt mission.⁵⁸ There must be a causal relationship between the trade or business and the organization's nonprofit mission in order for the trade or business to be "related" and thus exempt from UBIT.⁵⁹ Mere provision of funds for use in the nonprofit's charitable work is not sufficient to avoid the tax.⁶⁰ That is, the UBIT rules look to the *source* of the funds (and whether they were generated in an activity related to the organization's exempt mission) and not to the destination of the funds (that is, whether the funds were used in furthering the entity's exempt mission).

In the college and university setting, the biggest issue is normally whether the income was generated by an activity that is related to the institution's educational mission. Colleges and universities have been particularly lucky in this area, because they often generate substantial income from athletics via tickets sales and broadcast revenues. Such activities have historically been considered educational in nature, and thus exempt from UBIT.⁶¹

There are numerous exclusions or exemptions from UBIT.⁶² The most relevant one here is the exemption for passive-type of income such as interest, dividends, capital

⁵⁸ Treas. Reg. § 1.513-1(a).

⁵⁹ Treas. Reg. § 1.513-1(d)(2).

⁶⁰ *Id.*; I.R.C. § 513(a).

⁶¹ *See, e.g.*, Rev. Rul. 80-296, 1980-2 C.B. 195 (holding that the sale of broadcasting rights to an annual intercollegiate athletic event was exempt from UBIT because it furthered the organization's educational mission). *See supra* note 10, however, noting that the traditional view of athletic programs as primarily serving educational purposes has recently come under scrutiny.

⁶² Two exclusions are worthy of note. First, there is a "convenience" exception whereby a trade or business carried on by a college or university "primarily for the convenience of" its students or employees will not be considered an unrelated trade or business. I.R.C. § 513(a)(2). Accordingly, income from campus cafeterias and other food outlets will be exempt from UBIT. Second, "qualified sponsorship payments" (QSPs) are exempt from UBIT. I.R.C. § 513(i). A QSP is a payment a sponsor makes to a college or

gains, real property rents, and royalties.⁶³ Most of the income generated by college and university endowments falls into these categories, and therefore is exempt from UBIT. The exception for this type of income was made because it was generally considered appropriate for tax-exempt entities to generate such income and that passive investments did not raise unfair competition issues.⁶⁴

2. *Income from Debt-Financed Property*

One major exception to the passive income exclusion from UBIT relates to income from “debt-financed” property.⁶⁵ The debt-financed property rules are worthy of note because they are an expansion of UBIT similar to the one being considered currently: the expansion of UBIT to tax income earned by endowments. In addition, attempts by colleges and universities to avoid these rules in their endowment investments have played a role in the broader debate regarding the potential regulation and taxation of endowment income.⁶⁶

Stripped of detail, “debt-financed property” is property acquired to produce income which has “acquisition indebtedness” outstanding at any time during the year.⁶⁷

university (or another tax exempt organization) for “which there is no arrangement or expectation that [the sponsor] will receive any substantial return benefit other than the use or acknowledgement of the name or logo (or product lines)” of the sponsor. *Id.* Colleges and universities can thus generate substantial tax-free income from lucrative sponsorship agreements with respect to their athletic programs.

⁶³ I.R.C. § 512(b). The royalty exception to UBIT is particularly broad. A nonprofit can realize substantial tax-free income from royalties provided that the nonprofit does not provide services in exchange for the royalty payment. *See Sierra Club, Inc. v. Comm’r*, 86 F.3d 1526 (9th Cir. 1996). The UBIT exclusion for royalties is particularly lucrative for colleges and universities, which can license their name and logos for use on merchandise (such as clothing). If the income becomes significant enough, the Senate Committee on Finance may turn its attention to this issue next. *See supra* note 10 for prior, similar concerns congressional committees have raised with the higher education community.

⁶⁴ FISHMAN & SCHWARZ, *supra* note 31, at 427. *See infra* Part V for a more detailed discussion of the rationales underlying UBIT.

⁶⁵ I.R.C. § 512(b)(4) (indicating that passive income otherwise exempt from UBIT will nonetheless be considered income from an unrelated trade or business if the income was generated from debt-financed property); I.R.C. § 514 (defining debt-financed property).

⁶⁶ *See infra* notes 73-86 and accompanying text.

⁶⁷ I.R.C. § 514(b)(1).

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Acquisition indebtedness generally refers to the unpaid amount of debt used to acquire or improve the debt-financed property.⁶⁸ A portion of the income earned on such property will be deemed to be income from an unrelated trade or business, and, therefore, will be subject to UBIT.⁶⁹ The portion of income that will be taxed is equal to the gross income from the property times a fraction equal to the debt divided by the basis in the property.⁷⁰

The debt-financed property rules were put in place to prevent charities from exploiting their tax exempt status by entering into tax-motivated sale-leaseback transactions with for-profit enterprises.⁷¹ While targeted at real estate, the debt-financed property rules are much broader. For example, the debt-financed property rules result in the taxation of income earned from investments bought on margin.⁷²

If debt-financed property is held by a partnership in which the tax exempt organization is a partner, then the organization's share of income from the partnership will be subject to UBIT.⁷³ Therefore, if a college or university invests their endowment in a leveraged hedge fund, some of the income from the fund will be subject to UBIT under the debt-financed property rules. To avoid this result, colleges and universities will often use "blocker" entities.⁷⁴ A blocker entity is a corporation, formed under the laws of a low-tax foreign country.⁷⁵ The school invests in the stock of the blocker, which in turn

⁶⁸ I.R.C. § 514(c).

⁶⁹ I.R.C. § 512(b)(4).

⁷⁰ I.R.C. § 514(a). The amount subject to tax is reduced by deductions allocable to the debt financed property times the same fraction applied to gross income (debt divided by the basis in the property). *Id.* Several exceptions and special rules exist, which are not relevant here. *See generally* I.R.C. § 514.

⁷¹ FISHMAN & SCHWARZ, *supra* note 31, at 454.

⁷² *See, e.g.,* Bartels Trust v. U.S., 209 F.3d 147 (2d Cir. 2000) (indicating that the income earned by a university's supporting organization on margin-financed securities was subject to UBIT).

⁷³ *See* I.R.C. § 512(c)(1).

⁷⁴ McDowell Testimony, *supra* note 10.

⁷⁵ *Id.*

invests in the leveraged hedge fund.⁷⁶ The hedge fund passes the debt-financed income to the blocker.⁷⁷ Such income is not taxed to the blocker, since the blocker is incorporated in a foreign jurisdiction and is not engaged in a U.S. trade or business.⁷⁸ The blocker then passes the income to the school, in the form of dividends.⁷⁹ Because the dividends came from the blocker, which is NOT debt-financed, the income escapes UBIT.⁸⁰

There have been two reactions to blockers in Congress. One reaction was that the use of blockers was an abuse—an offshore circumvention of the debt-financed property rules.⁸¹ In line with this view, proposals were advanced to tax the income from blockers.⁸² The second reaction was that blockers are not abusive; they are simply used to avoid the debt-financed property rules in situations that were never intended to be covered by the rules.⁸³ The debt-financed property rules were put in place to attack tax-motivated sale-leaseback transactions, not mere investments in hedge funds.⁸⁴ In line with this view, proposals were introduced to exclude income from leveraged hedge funds from UBIT.⁸⁵ These proposals would allow endowments to invest in hedge funds directly (sans blockers) without being subject to tax.⁸⁶

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *See id.*; *see also* I.R.C. § 882(a).

⁷⁹ McDowell Testimony, *supra* note 10.

⁸⁰ *Id.*; Priv. Ltr. Rul. 199952086 (Sept. 20, 1999).

⁸¹ *See* Ryan J. Donmoyer, *Hedge-Fund Strategy by Harvard Gets Senate Scrutiny*, Bloomberg.com, May 8, 2007.

⁸² *Id.*

⁸³ *E.g.*, McDowell Testimony, *supra* note 10 (asserting that blockers are used simply to avoid the debt-financed property rules in situations “that were never intended to be within the scope of the rules”).

⁸⁴ *Id.*

⁸⁵ Press Release, Levin, Democrats Introduce Bill to Bring About Tax-Exempt Investments Onshore, Not Offshore, Sept. 7, 2007. The bill is available at http://www.house.gov/apps/list/press/mi12_levin/levin.pdf.

⁸⁶ *Id.*

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D. Summary

The basic rules reviewed in this Part show that private colleges and universities and the fundraising organizations supporting public colleges and universities are exempt from tax because they provide education, not because they provide immediate help for the needy. Further, these entities are subject to intermediate sanctions and the specter of losing tax-exempt status if any of their earnings inure to the benefit of entity managers or other insiders. These entities are also subject to lobbying and political campaign restrictions of questionable origin and rationales. Finally, these entities may be subject to UBIT on some of their income. With the exception of situations where the debt-financed property rules are triggered, however, most of the investment income earned by endowments will be exempt from tax. With this basic tax scheme established, we now take a closer look at the operational aspects of endowments.

III. ENDOWMENTS IN HIGHER EDUCATION

A. What is an “Endowment”?

When colleges, universities, the press, Congress, and commentators refer to an “endowment” they are normally speaking about an institution’s total reserve funds which may or may not have restrictions as to their use.⁸⁷ Note, however, that the legal term “endowment” has a much narrower meaning, referring only to funds that are legally restricted in their use by the donor.⁸⁸ College and university reserve funds include amounts restricted as to use by donors, amounts that are not legally restricted but which

⁸⁷ See Hansmann, *Endowments*, *supra* note 14, at 8; J. PETER WILLIAMSON, FUNDS FOR THE FUTURE: COLLEGE ENDOWMENT MANAGEMENT FOR THE 1990S I-5 (1993).

⁸⁸ *Id.* at 1-13. Donors may restrict the use of their gift, for example, for a scholarship, endowed faculty chair, funding for a research center, or to purchase specialty items, like rare books.

the institution has self-restricted (by earmarking them for specific purposes), and pure unrestricted funds.⁸⁹ Since the debate over these funds uses the term “endowment” in its broader colloquial sense (rather than in the narrow legal sense), this Article does likewise.

Critics tend to think about an endowment as one large “bank account.”⁹⁰ Colleges and universities, in contrast, claim an endowment represents thousands of separate accounts with specific, designated purposes (a named or endowed professorship, a scholarship, a center, etc.).⁹¹ There is some truth to both claims. An endowment is normally managed as one large investment pool,⁹² but internal records maintain separate accounts for each designated use. The overall investment pool earns income which is allocated to the individual accounts (perhaps net of a fee to support investment or fundraising staff). Annually, a fixed dollar amount or a designated portion of the earnings of each account is disbursed for the purpose of the account, such as in the form of a scholarship check for a deserving student. The payout rate and policy is established, in most cases, by the institution’s (or, in the case of a public institution, the supporting organization’s) governing body. Any income allocated to the account, in excess of any

⁸⁹ Hansmann, *Endowments*, *supra* note 14, at 8. These self-restricted funds are generally referred to as a “quasi-endowment.” WILLIAMSON, *supra* note 87, at I-5. Any self-restrictions may generally be removed at any time by the institution.

⁹⁰ *See, e.g.*, Munson Testimony, *supra* note 9 (focusing on the large total dollars in college and university endowments).

⁹¹ Higher Education Associations Testimony, *supra* note 10 (noting that “an endowment typically consists of hundreds—and in many cases, thousands—of individual funds provided by charitable gifts, as well as some institutional funds that are invested to support the institution’s mission in perpetuity”).

⁹² WILLIAMSON, *supra* note 87, at I-14 (noting that the trend is towards merging as many contributed funds as possible into common investment pools).

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fees, that is not currently paid accumulates in the account. This accumulation allows the account to maintain its value over time and provides a hedge against inflation.⁹³

Colleges and universities often have broad discretion as to what portion of endowment earnings should be spent or reinvested.⁹⁴ Also, as noted earlier, endowments contain not only funds restricted for specific purposes, but also self-restricted funds and unrestricted funds which could be spent at the discretion of the institution. As a result, “a substantial portion of endowed funds have been accumulated by institutional discretion and not donor command.”⁹⁵

B. Endowment Investment Practices

The recent phenomenal returns of endowments reflect professional management and modern investment practices.⁹⁶ Historically, endowments were invested in

⁹³ The generic overview provided here is per the author's discussion with William Ilett, Chair of the Board of Directors, Boise State University Foundation (the supporting section 501(c)(3) organization for Boise State University) (notes on file with author).

⁹⁴ Hansmann, *Endowments*, *supra* note 14, at 8. There is normally an issue over whether certain types of income generated on restricted endowment funds (for example, capital gains) can be spent currently or must be reinvested. See discussion at *infra* Part III.B.

⁹⁵ Hansmann, *Endowments*, *supra* note 14, at 8-9.

⁹⁶ In many ways, the recent success enjoyed by endowments reflects a broader trend of professionalism and business practices in higher education. In recent years, colleges and universities have become particularly adept at identifying hidden value in their institutions and then leveraging such value to generate new and unique streams of income. For example, many universities have received millions of dollars of additional revenue by entering into “exclusive provider agreements” with beverage companies. Under such arrangements, the institution guarantees that a beverage company (like Coca-Cola or PepsiCo) will have the right to be the only brand served at campus points of sale in exchange for donations, a variety of sponsorship payments, or a share of sales. See generally Mark J. Cowan, *A Coke, A Smile...And a Tax Bill? A Look at Exclusive Provider Agreements in Higher Education*, 3 ATA J. LEGAL TAX RESEARCH 49 (2005) (exploring the tax treatment of such contracts). In addition, many universities are now entering into lucrative arrangements with banks whereby the banks finance the cost of university identification cards, which also double as ATM cards. Dean Faust, *Even Cozier Deals on Campus; Joining Forces with Banks, Colleges are Now Cashing in on Student Debit Cards*, BUS. WK., Oct. 1, 2007, at 62. Colleges and universities are also adopting private-sector practices, such as outsourcing non-core functions like bookstores and food service. Ben Gose, *The Companies that Colleges Keep*, CHRON. HIGHER ED., Jan. 28, 2005, at B1. University athletics, of course, continue to generate lucrative television and sponsorship revenue. See, e.g., Stefan Fatsis, *It's Time for Money, uh, March Madness*, WALL ST. J., Mar. 16, 2004, at

conservative, fixed income investments, rather than equities.⁹⁷ Much of the reticence to expand into equities was based on traditional views of what portion of endowment income could be spent.⁹⁸ Traditionally, dividends received from stock investments were considered income that could be spent; capital gains/appreciation of the stock were not.⁹⁹ Most of the returns generated by stocks came from capital appreciation, rather than dividends.¹⁰⁰ In contrast, most of the income from bonds came from interest—which was clearly income that could be spent under traditional endowment spending practices.¹⁰¹ Thus, endowments avoided equity investments to ensure that the return from their investments could be currently spent, rather than added to the endowment’s principal.

Beginning in the 1960s, the booming stock market and rising rates of inflation made endowments rethink their reticence to invest in equities.¹⁰² In 1969, the Ford Foundation released a report critical of the conservative endowment practices of colleges and universities.¹⁰³ The report noted that the conservative investment approach taken by endowment managers was not mandated by law.¹⁰⁴ Rather, perceived legal restrictions on endowment investment activity were, in fact, “more legendary than real.”¹⁰⁵ The report thus advised endowment managers that they had “wide latitude in their choice of

R1. Some have become concerned that colleges and universities are becoming too commercial in their activities. See generally DEREK BOK, *UNIVERSITIES IN THE MARKETPLACE: THE COMMERCIALIZATION OF HIGHER EDUCATION* (2003) (reviewing the commercialization trend in higher education and cautioning that institutions should not compromise their values when seeking additional funds).

⁹⁷ WILLIAMSON, *supra* note 87, at 5-103.

⁹⁸ *Id.* at 5-104.

⁹⁹ *Id.* This view—that appreciation could not be spent—was based more on tradition than on legal mandates. See *infra* notes 103-106 and accompanying text.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.* at 5-103.

¹⁰³ WILLIAM L. CARY & CRAIG B. BRIGHT, *THE LAW AND THE LORE OF ENDOWMENT FUNDS: REPORT TO THE FORD FOUNDATION* (1969).

¹⁰⁴ *Id.* at 66.

¹⁰⁵ *Id.*

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investments” and urged them to keep pace with inflation by using this latitude to be more aggressive in their investments.¹⁰⁶

Following on the heels of the Ford Foundation’s report, many states enacted the Uniform Management of Institutional Funds Act.¹⁰⁷ The Act clarifies the duties of endowment managers and authorizes endowments to spend a prudent portion of the total return of the endowment investments—including not just interest and dividends, but capital gains as well.¹⁰⁸ Free to spend more types of income, endowments began to invest in more lucrative investments, such as stocks, that generated returns in the form of capital gains.¹⁰⁹

Today, endowments are managed much like other large investment pools.¹¹⁰ Endowments now invest in higher risk, higher yield investments such as emerging market equities, hedge funds, and venture capital firms.¹¹¹ These investments, while lucrative,

¹⁰⁶ See *id.* at 66.

¹⁰⁷ WILLIAMSON, *supra* note 87, at 5-106. This model law, as it applies to specific states, is *available at* <http://www.nccusl.org>. The model law applies to funds held by private charitable corporations, such as private colleges and universities and supporting organizations of public colleges and universities. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 1(1). The model law also applies to charitable or educational funds held by a governmental organization. *Id.* Accordingly, the model law applies to the endowments of both public and private institutions. In 2006, the National Conference of Commissioners on Uniform State Laws approved a revised, modernized model law, the Uniform Prudent Management of Institutional Funds Act, which is currently being considered by the states. The text of the new model law, and the status of state action on the model law, is *available at* <http://www.nccusl.org>. For a comparison of the old and new model laws, see http://www.nccusl.org/Update/Docs/UPMIFA_QuickCompare.pdf. Interestingly, the new model law allows states the option of presuming that a payout percentage of 7% is imprudent. See *id.*

¹⁰⁸ WILLIAMSON, *supra* note 87, at 5-106.

¹⁰⁹ *Id.* at 5-108.

¹¹⁰ Harvard’s endowment, for example, is professionally managed by investment experts at the Harvard Management Company, Inc., a wholly-owned subsidiary of the university. See <http://www.hmc.harvard.edu/>.

¹¹¹ See, e.g., Higher Education Associations Testimony, *supra* note 10; Harvard Management Company, Inc. Policy Portfolio Evaluation, at http://www.hmc.harvard.edu/investment_philosophy/ (showing the various categories of investments of the endowment at Harvard); John Hechinger, *Venture-Capital Bets Swell Stanford’s Endowment*, WALL ST. J., Jan. 23, 2006, at A1 (detailing Stanford’s lucrative investments in venture capital funds). Some of the most lucrative investments, such as those in venture capital firms,

can be volatile—delivering substantial returns in some years and substantial losses in others. For example, endowments overall experienced an average return of -6% in 2001-2002.¹¹² If an institution desires to smooth out the spending of endowment income (for example, it wants to give out the same amount in scholarships each year), it must spend less than the actual return in the profitable years and more than the actual return in the loss years. Although recent returns have been impressive, there is obviously no guarantee such performance will continue.¹¹³

In summary, colleges and universities have been getting more creative and aggressive in managing their endowment investments. They did so at the behest of experts who urged them to expand beyond conservative investments in order to maintain the real value of their endowment assets. The substantial returns currently being reported at some of the larger endowments are the result of this aggressiveness, and such returns cannot be counted on to continue in perpetuity.

C. Analyzing Endowments: Henry Hansmann's Study

In 1990, Henry Hansmann explored the issue of why endowments exist and how they are managed.¹¹⁴ Hansmann reviewed the arguments that are normally made in support of endowment accumulation and was very critical of endowment practices at colleges and universities—including at his own institution, Yale. Hansmann's analysis, the most relevant parts of which are summarized here, provides an excellent road map to the major practical and policy issues surrounding college and university endowments.

are generally only available to larger endowments, who can meet the minimum investment requirements and shoulder the risk such investments entail. *See id.*

¹¹² Higher Education Associations Testimony, *supra* note 10.

¹¹³ See *supra* note 7 (indicating that endowment officials are predicting a decline in returns for fiscal 2008).

¹¹⁴ Hansmann, *Endowments*, *supra* note 14, at 3.

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1. Intergenerational Equity

One of the principal arguments in favor of retaining and increasing endowment assets is that such action is necessary to foster intergenerational equity.¹¹⁵ To maintain intergenerational equity, the institution must manage the endowment so as to provide the same services to future generations of students as is provided to the current generation of students.¹¹⁶ In doing so, the current managers assume the institution will exist forever and will not receive future donations to augment the endowment.¹¹⁷ The current managers manage the endowment such that the current generation of students is not favored over future generations (and vice versa).¹¹⁸ Accordingly, spending more of an endowment's current income to reduce tuition or increase student services should not be done if it is expected to come at the expense of future generations of students.

Hansmann challenges the notion that retaining and expanding endowments is necessary to maintain intergenerational equity.¹¹⁹ First, Hansmann notes it is likely that the economy, over the long run, will continue to expand.¹²⁰ Therefore, future generations of students will likely be more prosperous than the current one.¹²¹ Under this view, it may be fairer to use endowment funds to help the current, less well-off generation of students at the expense of future generations of more well-off students.¹²²

Second, Hansmann takes issue with the assumption, made by advocates of intergenerational equity, that current endowment managers should not consider future

¹¹⁵ *Id.* at 14.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *See id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

donations.¹²³ There is no reason to believe that future gifts will not be forthcoming.¹²⁴ If gifts can be anticipated, they should be considered in the analysis over whether to spend endowment earnings.¹²⁵ The more gifts that can be anticipated, “the more reason to spend, not save, current gift income.”¹²⁶

Third, Hansmann takes issue with the argument, advanced by intergenerational equity devotees, that endowment accumulation is necessary to provide the same level of education to future generations, since the cost of providing that education is likely to be much higher than it is today.¹²⁷ Hansmann notes that demand for education is not completely inelastic, and therefore cost becomes a factor as to how much education students will consume at a college or university.¹²⁸ If the cost is kept high, less will be consumed. If the cost is kept low, more will be consumed. If today’s education costs are kept artificially high (by accumulating endowment income) and tomorrow’s education costs are kept artificially low (by spending endowment income that was accumulated), then there will be less consumption of education today and more consumption of education tomorrow.¹²⁹ “This would simply be substituting a more expensive good for a cheaper one.”¹³⁰ Hansmann concludes that “[t]axing education through endowment accumulation in the present in order to subsidize it in the future only distorts consumption

¹²³ *Id.* at 16.

¹²⁴ *Id.* In fact, if no future gifts are expected, this would indicate there is little ongoing public support. This might call into the question the very need for the continued existence of the institution. A lack of donations would also call into question the rationale for granting the institution tax-exempt status—at least under the “donative” theory of tax exemption. The donative theory of tax exemption is discussed at *infra* Part IV.A.3.

¹²⁵ Hansmann, *Endowments*, *supra* note 14, at 16.

¹²⁶ *Id.*

¹²⁷ *Id.* at 17.

¹²⁸ *Id.*

¹²⁹ *See id.*

¹³⁰ *Id.*

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of education both within and across generations, leading us to consume too little of it today and too much tomorrow.”¹³¹

Fourth, Hansmann claims that colleges and universities are poorly positioned to preserve and transfer wealth to the next generation.¹³² Colleges and universities exist primarily to create and pass on knowledge, not to create and pass on wealth.¹³³ The task of passing on wealth to the next generation is best left to the federal government, through fiscal and monetary policy.¹³⁴ Colleges and universities are in a far better position to promote *intragenerational* equity, by using more of their endowment earnings to help indigent individuals get an education, than to promote intergenerational equity.¹³⁵ Any attempt by colleges and universities to promote intergenerational equity by retaining endowment income comes at the expense of intragenerational equity.¹³⁶

Fifth and finally, Hansmann raises the issue of whether *financial* accumulation is the only way to foster intergenerational equity.¹³⁷ Colleges and universities should weigh the benefits of building endowments to help future students against the benefits of spending some of the endowment income currently on research, teaching, cultivation and development of faculty, construction of facilities, and other educational activities.¹³⁸ Such activities are likely to have a profound impact on future generations.¹³⁹ If a college or university decides to add to its endowment rather than spend gifts or income currently

¹³¹ *Id.* at 17-18.

¹³² *Id.* at 18.

¹³³ *Id.*

¹³⁴ *Id.* Hansmann notes that while the government can strive to promote intergenerational equity in general, the most a private institution, such as a college or university, can do is strive to promote intergenerational equity with respect to a subset of society—the institution’s current and future students. *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

on teaching, research, facilities, etc. then “it is implicitly making the judgment that the [amount not spent] will have a higher rate of return if invested in stocks and bonds than in educating an undergraduate, or doing research in biophysics, or adding books to the library.”¹⁴⁰

2. “Lumpy” Funding

Another argument in favor of endowment accumulation is that it is particularly necessary when an institution’s donations are “lumpy,” with some large gifts in some years and few or small gifts in other years.¹⁴¹ This can be the case, for example, where a major donor makes a significant contribution that is not expected to be recurring or where an institution raises most of its funds during intensive capital campaigns.¹⁴² Hansmann argues however, that donations are less lumpy than they used to be, given the continuous fundraising that goes on in modern colleges and universities.¹⁴³ Further, even where donations are lumpy, this does not justify accumulating *permanent* endowment funds.¹⁴⁴

3. Tax Incentives for Current Giving

¹⁴⁰ *Id.* The for-profit analog of this issue occurs when a corporation hoards cash to reduce risk rather than investing in potentially more profitable business operations. Corporations that engage in such behavior are normally not maximizing shareholder value (shareholders, after all, can invest cash on their own) and are ripe for takeover. *See generally* Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988) (discussing the “free cash flow theory” that holds that managers who hoard excess cash rather than investing it or distributing it to shareholders create inefficiencies that may be corrected by the market for corporate control).

¹⁴¹ Hansmann, *Endowments*, *supra* note 14, at 19.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

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Another argument for endowment accumulation is that it lets the institution encourage donors to give currently, rather than in the future.¹⁴⁵ This is because of the tax incentive to do so. For example, say that a potential donor plans to make a major contribution to a college at her death.¹⁴⁶ Instead, she can give a lesser gift now equal to the present value of the planned gift. She can prohibit the college from spending the gift until her death. The college can then invest the gift and earn income tax free. Had the donor invested the funds personally, she would have paid tax on the income from the investments, lowering the return. By transferring a discounted gift today, the gift is ultimately of a greater benefit to the college. These “early” restricted gifts may explain some part of endowment accumulation.¹⁴⁷

Hansmann believes the tax incentive to give early is not the primary driver of endowment accumulation, however, given that there is evidence of accumulation even prior to the enactment of the income tax.¹⁴⁸ In addition, just because there is a tax incentive to accumulate does not necessarily mean it is good policy for the institution to continue to accumulate their endowment earnings in such a fashion.¹⁴⁹

4. *Maintaining Liquidity*

Another argument that is made in favor of endowment accumulation is that the funds can help the institution survive financial shocks.¹⁵⁰ For example, a recession or shift in demographics may reduce enrollment (and associated tuition income) or an

¹⁴⁵ *Id.* at 20.

¹⁴⁶ This example is adapted from the one at *id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 21.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

energy crisis may trigger higher costs.¹⁵¹ Hansmann notes that businesses also are subject to unexpected financial shocks, but they rarely maintain large financial reserves.¹⁵² A business, however, can borrow additional funds, shutter plants, layoff employees, and take other measures to ride out the financial crisis.¹⁵³ A college or university is less likely to be able to borrow additional funds in the event of a crisis.¹⁵⁴ Further, tenure prevents layoffs from providing significant short-term cost savings.¹⁵⁵

Hansmann notes, however, that some universities accumulate far more endowment assets than necessary to survive short-term financial setbacks¹⁵⁶ and there is little evidence that institutions like Yale have relied on spending down their endowments to help out during financial setbacks.¹⁵⁷

In addition, as noted earlier, many universities began to invest in stocks starting in the 1960s.¹⁵⁸ Institutions began to spend more of their increased endowment income (including capital gains) on increased operating budgets.¹⁵⁹ When the stock market declined, however, endowment values began to decrease and endowment income was not able to keep up with the higher operating budgets.¹⁶⁰ Colleges and universities blamed their aggressive spending from endowments for contributing to their budgetary

¹⁵¹ *Id.* Note that Hansmann is using these as examples of *possible* financial shocks. Not all of these possible events would necessarily have a negative effect on the institution. A recession, for example, could either reduce enrollment (since fewer students could afford to pay tuition) or increase enrollment (because students choose to further their education rather than enter a lackluster job market). A recession could also lead to decreased state funding of public institutions and tighter budgets. *See, e.g.,* David L. Wheeler, *Colleges Prepare for Fiscal Downturn*, CHRON. HIGHER ED., Feb. 8, 2008, at A1.

¹⁵² Hansmann, *Endowments*, *supra* note 14, at 21.

¹⁵³ *See id.*

¹⁵⁴ *Id.* at 22.

¹⁵⁵ *Id.* Financial exigency, however, is often grounds for revoking tenure. *Id.* at 23.

¹⁵⁶ *Id.* at 22. Hansmann notes (at the time he was writing) that Yale could use the unrestricted portion of its endowment to survive eight years at its current budget if all of its other sources of support evaporated. *Id.*

¹⁵⁷ *Id.* at 24.

¹⁵⁸ *See supra* Part III.B.

¹⁵⁹ Hansmann, *Endowments*, *supra* note 14, at 26.

¹⁶⁰ *Id.*

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problems.¹⁶¹ Accordingly, colleges and universities, while continuing to aggressively invest their endowments, became more conservative in spending their endowment income.¹⁶² From this, Hansmann concludes that endowments are accumulating not as a buffer against financial difficulties, but rather to keep operating budgets from rising as fast as they did in the 1970s.¹⁶³

5. Long-Term Security

Another reason for endowment accumulation is to help the institution through longer-term adverse circumstances.¹⁶⁴ The theory here is that the endowment exists to keep the institution from liquidating in the face of sustained operating losses.¹⁶⁵ In the for-profit world, it is normally more efficient to liquidate in the face of a long period of losses rather than to continue using retained earnings to stay in business.¹⁶⁶ Colleges and universities, however, may wish to use their endowments to stay in existence, despite continued losses, to preserve their reputational capital and tradition.¹⁶⁷

Colleges and universities may feel that they need to stay in existence for the sake of their alumni.¹⁶⁸ The theory being if the institution were to liquidate, its degrees and reputation would be hurt.¹⁶⁹ Further, prospective students would be drawn to institutions with larger endowments. Well-endowed institutions would be less likely to liquidate and damage the value of their degrees.¹⁷⁰ Hansmann questions, however, the importance of

¹⁶¹ *Id.* at 25.

¹⁶² *Id.* at 26.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 27.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* at 27-28.

¹⁶⁸ *See id.* at 27.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

this rationale for endowment accumulation.¹⁷¹ It is likely, in Hansmann’s view, that students often get most of their value from the institution while they are studying there—not years later from the continued glow of the institution’s reputation.¹⁷²

A college or university may also view its endowment as necessary to ensure its continued existence to keep its tradition alive.¹⁷³ “Tradition” is the analog of goodwill in the for-profit world.¹⁷⁴ Long-lived institutions often accumulate a valuable reputation and well-known traditions.¹⁷⁵ This helps attract students, faculty, and additional donations.¹⁷⁶ Hansmann notes, however, that tradition may be best maintained and fostered by spending more endowment income to preserve the quality of education currently being offered.¹⁷⁷ Further, there are few examples of long-lived institutions liquidating because of financial problems.¹⁷⁸ Accordingly, endowment accumulation may not be justified as a way to maintain the institution’s tradition.

6. Insulation from Outside Demands

Another reason for endowment accumulation is that it helps to insulate the college or university from the demands of donors, students, the government, or other sources of ongoing support.¹⁷⁹ This insulation can allow the administration of the institution to express unpopular ideas without fear of the short term financial consequences (in reduced

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ *Id.* at 28.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* at 28.

¹⁷⁹ *Id.* at 29.

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donations or government support) that might ensue.¹⁸⁰ Hansmann found little evidence that this was actually the reason for endowment accumulation.¹⁸¹

Further, Hansmann notes that insulation cannot entirely justify endowment accumulation.¹⁸² On the one hand, an endowment can “help keep the maintenance of culture and the pursuit of knowledge from being blown about unduly by the shifting winds of ideology and interest”.¹⁸³ On the other hand, endowments “may provide an unfortunate opportunity for irrelevance and sloth.”¹⁸⁴ Ironically, while the goal of insulation may somewhat justify endowment accumulation, colleges and universities may have the best argument against minimum distribution requirements if they can show they are *not insulated* from constituents.¹⁸⁵

7. Other Explanations for Endowment Accumulation

Hansmann notes a few other possible reasons for endowment accumulation that perhaps are less justified (from a societal standpoint) than those listed thus far. Donors, for example, may be more motivated to give endowed gifts rather than unrestricted gifts in order to “purchase a bit of personal immortality.”¹⁸⁶ Perpetual restrictions on the use

¹⁸⁰ *Id.* With regard to public institutions, one government-relations officer has noted that politicians should welcome outside sources of income (such as from an endowment) since they reduce reliance on state funds. Peter O'neal, *Five Reasons Politicians Hate Us*, CHRON. HIGHER ED., Oct. 2, 2007. In reality, however, many politicians don't like endowments because they make state colleges and universities “free from being a slave to political largesse.” *Id.*

¹⁸¹ Hansmann, *Endowments*, *supra* note 14, at 29-32. See also *infra* note 322, indicating that colleges and universities with large endowments continue to seek outside funds.

¹⁸² Hansmann, *Endowments*, *supra* note 14, at 32.

¹⁸³ *Id.* Some have questioned, however, whether even Yale, with its substantial endowment, has appropriately maintained its tradition and historic mission. See generally WILLIAM F. BUCKLEY, JR., GOD AND MAN AT YALE (50th Aniv. ed. 2002) (documenting Yale's deviation from its historic religious and economic teachings).

¹⁸⁴ Hansmann, *Endowments*, *supra* note 14, at 32.

¹⁸⁵ See *infra* Part VI.C.

¹⁸⁶ Hansmann, *Endowments*, *supra* note 14, at 33.

of property are generally forbidden in the law, except when it comes to charitable gifts.¹⁸⁷ Accordingly, restricted gifts to charity (including gifts to college and university endowments) are one of the few ways that an individual can permanently perpetuate his desires. Such desires and restrictions are usually strictly enforced.¹⁸⁸ Unless and until the liberal allowance of perpetual restrictions on charitable gifts is reformed, however, it remains a reason for endowment accumulation.¹⁸⁹

Another reason for endowment accumulation is the risk reduction behavior of college and university administrators and faculty.¹⁹⁰ Faculty and administrators, the theory goes, would rather accumulate surplus funds to enhance their job security than expand programs.¹⁹¹ Expanding instead of saving could put faculty and administrator jobs at risk in future economic downturns.¹⁹² Accordingly, the incentive is to be conservative and save. Similar behavior occurs in the for-profit sector, where managers

¹⁸⁷ *Id.* at 34.

¹⁸⁸ *Id.* Modifications to restricted gifts are generally only possible under the very limited cy pres doctrine. *Id.* In general, to use cy pres, it must be nearly impossible to carry out the donor's original intent. See Ilana H. Eisenstein, *Keeping Charity in Charitable Trust Law: The Barnes Foundation and the Case for Consideration of Public Interest in Administration of Charitable Trusts*, 15 U. PA. L. REV. 1747, 1768 (2003). While the allowance of perpetual restrictions on charitable gifts helps to encourage giving, it can also lead to odd results of questionable societal benefit. For example, a wealthy donor, Beryl H. Buck, left an endowment restricted to benefit the needy of Marin County, California. *Id.* at 1770. After Buck's death in 1975, Marin County became one of the wealthiest areas of the country, with few needy individuals. *Id.* At the same time, the value of the endowment grew dramatically (from \$9.1 million at Buck's death to nearly \$400 million by the mid-1980s) through lucrative investments. *Id.* Nonetheless, courts refused to apply cy pres to allow the endowment to be used for needy individuals outside of Marin County. *Id.* at 1771. As a result "hundreds of millions of dollars remain dedicated to helping the practically nonexistent needy in one of America's wealthiest suburbs." *Id.* Such is the price we pay for allowing charitable gifts to be restricted in perpetuity. The issue of perpetual restrictions on gifts is, however, a long-standing controversial issue that is much broader than the present issue over whether and how college and university endowments should be regulated. For more on the arguments for and against perpetual restrictions on charitable gifts, see generally *id.*

¹⁸⁹ But see *infra* Part VI.C for a discussion of modern philanthropists that would rather see their gifts spent currently than restricted in perpetuity.

¹⁹⁰ Hansmann, *Endowments*, *supra* note 14, at 35.

¹⁹¹ *Id.* at 36.

¹⁹² See *id.*

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would rather accumulate funds to ensure liquidity (and job security) than invest in value-maximizing ventures that carry significantly more risk.¹⁹³

Endowments also may accumulate because of the preferences of trustees.¹⁹⁴ Hansmann notes that trustees may have little expertise when it comes to the actual operations of the college or university, but they often have a great deal of acumen when it comes to endowments.¹⁹⁵ Accordingly, trustees often see their job as effectively building and managing endowments.¹⁹⁶ They tend to judge their success by benchmarking their endowments against sister institutions.¹⁹⁷

Finally, Hansmann notes that endowments may accumulate simply out of custom or habit.¹⁹⁸ Older schools have always accumulated endowments and the newer schools simply emulate them.¹⁹⁹

8. *Hansmann's Conclusions*

Clearly, Hansmann takes serious issue with endowment accumulation policies. He did, after all, sharply question each of the identified rationales for endowment accumulation. Nonetheless, he does not call on the federal government to regulate endowments. In fact, he does the opposite:

Given the poor state of our understanding, it would be premature to propose changes in the law governing endowment accumulation and, in particular, to propose measures to limit the discretion of universities to accumulate large endowments. Moreover, the importance of adopting

¹⁹³ *Id.* at 36-37. See also the discussion at *supra* note 140.

¹⁹⁴ Hansmann, *Endowments*, *supra* note 14, at 37.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.* at 37-38.

¹⁹⁸ *Id.* at 39.

¹⁹⁹ *Id.*

such restrictions is lessened by the fact that even substantially excessive endowment building may lead to only a limited amount of waste from a social welfare standpoint. Because funds that a university devotes to endowment are today typically invested in market securities, they are at least being used productively. Indeed, efforts to limit endowment accumulation might in part have the effect of diverting universities toward other, less efficient forms of accumulation (for example, useless facilities or excessive esoteric research by faculty) or toward unproductive current spending.²⁰⁰

Thus, even one of the most ardent critics of endowment policies is against government control. Hansmann does, however, note the benefits of the *threat* of government control.²⁰¹ The specter of legislation can be “a useful stimulus to universities . . . to satisfy themselves and others that their policies towards endowment accumulation are reasonable in light of the ends to which their institutions are dedicated.”²⁰² In this light, the September 2007 hearings in the Senate Committee on Finance should incite colleges and universities to rethink their endowment policies.²⁰³ Such rethinking may, in and of itself, address the concerns of endowment critics more effectively than actual government regulation.

IV. RATIONALES FOR TAX EXEMPTIONS

We now turn our attention to the rationales underlying the tax exemption for colleges and universities to see what light they shed on the issue of whether to tax endowment income. There is no generally accepted, underlying theory of tax exemption. Commentators have disagreed over the rationales behind granting tax exemptions to

²⁰⁰ *Id.* at 40.

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ In fact, there appears to be some rethinking already taking place. See *infra* notes 328-329 for recent moves by Harvard, Yale, and other institutions to spend more of their endowment on financial aid—at least partially in response to the September 2007 hearings in the Senate Committee on Finance.

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nonprofit organizations such as colleges and universities. Note that the theories reviewed here primarily seek to explain the rationales for granting the nonprofit entity a tax exemption; they are not designed to explain the rationale for giving donors to nonprofits a tax deduction.

A. Subsidy Theories

Most of the theories supporting tax exemption view the exemption as a government subsidy. This Part IV.A will focus on three subsidy theories: the traditional public benefit subsidy theory, the capital subsidy theory, and the donative theory.

1. Traditional Public Benefit Subsidy Theory

Perhaps the most widely held view of tax exemption is that it exists to provide a government subsidy to the nonprofit sector.²⁰⁴ The subsidy is justified on the grounds that nonprofits are providing services that the government is not able or willing to provide.²⁰⁵ The courts generally agree with this theory.²⁰⁶

Under the traditional public benefit subsidy theory's view, tax exemption is granted to worthy activities (such as education) to "aid and stimulate private charitable enterprise, *without subjecting it to control.*"²⁰⁷ The lack of government control is a key part of the tax exemption regime:

The income of each individual organization is a product of donations it receives and the investment wisdom of its managers. Since all of these operations are out of the hands of government under the exemption and

²⁰⁴ FISHMAN & SCHWARZ, *supra* note 31, at 76.

²⁰⁵ *Id.*

²⁰⁶ *E.g.*, *Bob Jones Univ. v. U.S.*, 461 U.S. 574, 589-92 (1983).

²⁰⁷ FISHMAN & SCHWARZ, *supra* note 31, at 77 (quoting Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy in the 1977 Filer Commission Research Papers*) (emphasis added).

deduction statutes, the beneficiary organizations receive their government aid without having to petition for it. They are, therefore, in [Harvard] President Eliot's words ". . . untrammled in their action, and untempted to unworthy acts or mean compliances."²⁰⁸

Accordingly, the exemption is given without control, beyond those restrictions discussed above in Part II (regarding restrictions on inurement, lobbying, campaigning, etc.). In this way, the tax exemption system helps nonprofits contribute to "a robust and pluralistic American society" in their "role as innovators and efficient providers of public benefits."²⁰⁹ Inherent in this "hands-off" subsidy approach is that "[e]ffort may be wasted, mistakes may be made, agencies may even work at cross-purposes; but in the long run the well-being of mankind is thus fostered. The basic premise of the system is that progress comes through freedom."²¹⁰

The traditional "hands-off" view of the subsidy has been lost in the debate over endowment accumulation. One key staffer on the Senate Committee on Finance commented that the government was entitled to inquire and interfere in endowment decision-making because of the tax exemption granted to educational institutions.²¹¹ He was quoted as saying "Give back the tax break, and we'll leave you alone."²¹² Clearly, this attitude is inconsistent with the traditional public benefit subsidy theory.

2. Capital Subsidy Theory

Henry Hansmann, whose views on endowments were discussed above in Part III, has also articulated a "capital subsidy" justification for granting tax exemption to

²⁰⁸ *Id.*

²⁰⁹ *Id.* at 76.

²¹⁰ *Id.* at 77 (quoting Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy in the 1977 Filer Commission Research Papers*).

²¹¹ Goldie Blumenstyk, *Colleges' Endowments-Spending Prerogatives Get Unexpected Defense*, CHRON. HIGHER ED., Feb. 4, 2008 (quoting key Senate aide Dean A. Zerbe).

²¹² *Id.* (quoting key Senate aide Dean A. Zerbe).

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nonprofits.²¹³ Under this theory, tax exemption helps to remedy the difficulty nonprofits have in raising capital.²¹⁴ Nonprofits cannot issue stock (because of the nondistributional constraint), and have limited access to debt financing.²¹⁵ Therefore, nonprofits must rely on their retained earnings, both as a source of financing and a source of an income stream to support borrowings.²¹⁶ If nonprofits were taxed, then their retained earnings would be reduced by 35% (at current tax rates), reducing their access to capital.²¹⁷ Therefore, the tax exemption can be viewed as a subsidy for nonprofit capital.²¹⁸

3. Donative Theory

The donative theory of tax exemption was developed by Mark Hall and John Colombo.²¹⁹ Under this theory, tax exemption is considered a subsidy. The subsidy is justified where neither the government nor the private market effectively provide a service demanded by a significant number (but not a majority) of citizens.²²⁰ In order for the government to assume a duty, there must generally be majority support.²²¹ In the

²¹³ Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981).

²¹⁴ *Id.* at 72.

²¹⁵ *Id.*

²¹⁶ *Id.* at 73-74.

²¹⁷ *See id.* at 74 (the tax impact would have been to cut retained earnings in half at the corporate tax rates in place at the time of Hansmann's article).

²¹⁸ *Id.*

²¹⁹ The theory was originally explained in Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379 (1991). Most of the discussion here is drawn from Professor Colombo's application of the donative theory to educational institutions in John D. Colombo, *Why is Harvard Tax Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841 (1993).

²²⁰ *Id.* at 875.

²²¹ *Id.* at 874.

absence of such support, needs of significant sectors of society may go unmet.²²² Tax exemption thus provides a way for the government to subsidize important services without needing majority support or the ability to control the organizations providing the services.²²³ Voters will support tax subsidies for services provided by minority-supported organizations they have no interest in because they, in turn, receive tax subsidies for services provided by other minority-supported organizations which they care about.²²⁴

Hall and Colombo use donations as a proxy for public support.²²⁵ If an organization receives enough public support (say, 10% of their receipts are from donations), then the organization is doing something important that a significant segment of society wants to see done but which is not being done by the government or the private sector.²²⁶ As such, the organization is entitled to the tax exemption. The use of donations as a measure of exemption-worthiness separates traditional nonprofits from for-profit institutions, which may also benefit society but do not receive donations.²²⁷

Higher education fits neatly into this theory. Most private colleges and universities would meet Hall and Colombo's donation test.²²⁸ This means that colleges and universities are supported by enough of the public such that exemption is justified.

²²² *Id.*

²²³ *Id.* at 875.

²²⁴ *Id.* Colombo calls this the “ ‘I’ll scratch your back if you’ll scratch mine’ social compact among high-demanding groups with widely divergent preferences.” *Id.* Someone interested in opera, for example, is willing to allow the government to subsidize a tax break for studies of ruffled grouse because students of ruffled grouse are willing to allow a government subsidy for opera. *Id.*

²²⁵ *See id.* at 876.

²²⁶ *Id.* at 876-79.

²²⁷ *Id.* at 879.

²²⁸ *Id.* at 882-85.

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4. Application of the Subsidy Theories to Endowments

A tax on endowment income would be inconsistent with the subsidy theories. Presumably Congress would justify the tax on the fact that invested income was not being used to help current students at colleges and universities. The hallmark of the traditional public benefit subsidy theory, however, is that tax exemption is given without control. So long as the institution is “educational,” it should be entitled to run its affairs (including its investments) as it deems appropriate in carrying out its mission.

Under the capital subsidy theory, the tax exemption exists to ensure that retained earnings can be used as a source of capital. Endowments represent a pool of capital that colleges and universities can use in carrying out their missions. Accordingly, if the exemption is a capital subsidy, there certainly shouldn't be a tax on the income earned by endowments.

Finally, under the donative theory, so long as colleges and universities, despite their sizable endowments, continue to receive a significant amount of donations, their tax exemption would be justified. Thus, the donative theory would not support a tax on endowment income unless and until donations significantly decline.²²⁹

²²⁹ See *supra* Part III.C.6 regarding the theoretical ability of colleges and universities to insulate themselves from the demands of constituents—including donors—by relying on their endowments. The donative theory provides an excellent check on such power. If donations are not forthcoming, then tax exemption should be denied—and all of the college or university's income (including the earnings on endowments) should be subject to tax. We have not reached this point yet, but may someday if enough donors decide to donate to “more needy” schools. See discussion at *infra* note 325 and accompanying text.

B. Income Measurement Theory

The one leading theory that does not claim that tax exemption is a subsidy is the “income measurement” theory set forth by Boris Bittker and George Rahdert.²³⁰ Under this theory, “public service” nonprofit organizations, such as colleges and universities, are exempt from tax because there is no accurate way to truly calculate their “income.”²³¹ Bittker and Rahdert provide an example of a health care provider that can easily be adapted to cover a college or university:²³²

| | |
|---|--------------|
| 1. Interest from Endowment | \$100 |
| 2. Tuition | 25 |
| 3. Gifts and Bequests | <u>75</u> |
| 4. Total Receipts | \$200 |
| 5. Salaries of Staff | \$25 |
| 6. Scholarships/Need-based aid | <u>125</u> |
| 7. Total Disbursements | <u>\$150</u> |
| 8. Receipts Less Disbursements (line 4 less line 7) | <u>\$50</u> |

Bittker and Rahdert state that the interest from the endowment is clearly income under general principles of tax law, but the rest of the receipts and disbursements do not fit neatly into existing concepts of income and deduction under the Internal Revenue

²³⁰ Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976).

²³¹ *Id.* at 305.

²³² This example is adapted from *id.* at 308. The only significant modification was to change line 2 to “tuition” from “membership dues” in the original.

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Code.²³³ For example, is tuition taxable income?²³⁴ Are staff salaries deductible ordinary and necessary business expenses when they were NOT incurred with the motive of generating a profit?²³⁵ Even where income is clear, as is the case with earnings on endowments, uncertainty with regard to the other items of receipts and disbursements destroys the ability to tax the endowment income. This is because the federal income tax is a *net* income tax that should consider all income less all allowable deductions and not merely identified items of income. Because of these difficulties, nonprofits were granted tax exempt status, not as a subsidy, but merely to avoid the task of tweaking existing definitions of income to accommodate common nonprofit receipts and disbursements.²³⁶

Even if income could be calculated for nonprofits, there is no way to set the appropriate tax rate.²³⁷ The idea is that if the nonprofit were taxed, the economic incidence of the tax would be passed on to the beneficiaries of the nonprofit's services.²³⁸ Therefore, the tax rate should be set by reference to the ability of beneficiaries to pay.²³⁹ Given the number and diversity of beneficiaries, this would be difficult to accomplish in practice.²⁴⁰ Any rate chosen would therefore be arbitrary and likely be too high with respect to most beneficiaries.²⁴¹

²³³ *Id.*

²³⁴ *Id.*

²³⁵ *Id.* at 309-10.

²³⁶ *See id.* at 305. *But see* Colombo, *supra* note 219, at 860 (arguing that it is possible to calculate the income of a college or university within existing notions of taxable income and speculating that institutions like Harvard "could come up with a taxable income number if pressed to do so").

²³⁷ Bittker & Rahdert, *supra* note 230, at 314.

²³⁸ *Id.* at 315. This assumes that donors do not increase their gifts to cover the tax. *Id.* The true economic incidence of tax is, of course, often difficult to determine.

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ *Id.*

In educational institutions, the beneficiaries are primarily students, who are likely, on average, to be wealthier than beneficiaries of other charitable entities, and thus have more ability to pay any tax that is passed on to them.²⁴² Bittker and Rahdert nonetheless contend that their income measurement theory applies to support the exemption for educational institutions:

We do not mean to imply, however, that students are the only beneficiaries of the money spent by schools and colleges or that art galleries and symphony orchestras are merely the playthings of the rich. Only a philistine would doubt that these institutions provide benefits, directly and indirectly, to an indefinably wide audience over the entire income spectrum. . . . [These] activities are no less charitable in the eye of the law because incidentally they benefit the rich as well as poor, as indeed every charity must do, either directly or indirectly. Moreover, it is precisely in the area of education, including the arts, that private institutions are especially well suited to serve as independent centers of power and influence in our society, fostering innovation and diversity with a dedication that government agencies can seldom muster or sustain.²⁴³

The income measurement theory, even though designed with educational institutions in mind, does not perfectly translate into the realm of modern colleges and universities. First, modern colleges and universities are acting in more entrepreneurial, businesslike ways, perhaps making income measurement easier.²⁴⁴ Second, the income measurement theory assumes that any tax imposed would be borne by the charitable class—here presumably that would be the students.²⁴⁵ Given the recent returns enjoyed by endowments, however, chances are that colleges and universities would be able to absorb the tax and avoid placing the burden on students.

²⁴² *Id.* at 334.

²⁴³ *Id.* at 334-35.

²⁴⁴ See *supra* note 96. See also Colombo, *supra* note 219, at 859.

²⁴⁵ But see *supra* note 243 and accompanying text for an argument that the beneficiary class includes more than just students.

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The Tax Expenditures Budget, which lists special tax breaks and documents the revenue the federal government forgoes from offering those breaks,²⁴⁶ implicitly adopts the income measurement theory. The tax exemption for charities and educational institutions is not considered a tax expenditure.²⁴⁷ The rationale is that the activity of nonprofits does not involve business activity and thus any income nonprofits earn falls outside the realm of the normal income tax.²⁴⁸ The charitable deduction that donors receive for their gifts to colleges and universities, however, is considered a tax expenditure, and thus a subsidy.²⁴⁹ This treatment in the Tax Expenditures Budget, however, is controversial.²⁵⁰

If one accepts the income measurement theory, then the tax exemption for colleges and universities is not derived from a subsidy and, thus, the government need not be concerned with policing endowment policy in higher education—since it has not granted a “subsidy” for which it can demand a return benefit. The view, however, that tax exemption is not a subsidy is a minority one that has not found favor in the eyes of the courts or other commentators.²⁵¹

V. RATIONALES FOR THE UNRELATED BUSINESS INCOME TAX

Just as there is no one theory supporting tax exemption, there is no one, unified theory justifying the existence of UBIT. This Part reviews some of the theories that have

²⁴⁶ Joint Committee on Taxation, Estimates of Federal Tax Expenditures For Fiscal Years 2007-2011 (JCS-3-07, Sept. 24, 2007) available at <http://www.house.gov/jct/s-3-07.pdf>.

²⁴⁷ *Id.* at 7.

²⁴⁸ *Id.* at 7-8.

²⁴⁹ *See, e.g., id.* at 32 (estimating \$36.8 billion of forgone revenue as a result of allowing a deduction for donations made to educational institutions; this presumably includes educational institutions of all types and levels—not just colleges and universities).

²⁵⁰ *See, e.g.,* FISHMAN & SCHWARZ, *supra* note 31, at 79.

²⁵¹ Colombo, *supra* note 219, at 861. Instead commentators (and courts) generally view tax exemption as a subsidy. *Id.* See *supra* Part IV.A.

been advanced in support of UBIT and whether these theories would support the extension of the UBIT regime to endowment income.²⁵²

A. Unfair Competition

The major reason Congress gave for enacting UBIT in 1950 was to address concerns over unfair competition.²⁵³ The fear was that nonprofits were acquiring businesses and then using their tax exemptions to unfairly compete with their for-profit (taxable) counterparts. In fact, this fear was driven by business ventures in higher education. New York University, for example, had acquired all of the stock in the C.F. Mueller Company, which produced and sold macaroni.²⁵⁴ The Court of Appeals for the Third Circuit ultimately held that the C.F. Mueller Company was exempt from the federal income tax because all of its income went to benefit a tax exempt organization, the New York University School of Law.²⁵⁵ As the C.F. Mueller case was making its way through the courts, Congress felt compelled to enact UBIT or else “all noodles produced in this country will be produced by corporations held or created by universities.”²⁵⁶

The commentary has not been kind to the unfair competition explanation for the existence of UBIT. The C.F. Mueller example aside, there is little empirical evidence

²⁵² Obviously, not all the possible theories of UBIT can be examined here. Instead, those theories that are frequently cited or particularly applicable to the issue of endowments are presented.

²⁵³ FISHMAN & SCHWARZ, *supra* note 31, at 377-78 (quoting Congressional reports for this proposition). Another reason given for the enactment of UBIT was to raise revenue to finance the Korean War. *Id.* at 378 (quoting President Truman’s statement at the time UBIT was proposed). It is perhaps appropriate that the UBIT regime is still in place today, given that the Korean War has yet to formally end. See Evan Ramstad, *Politics & Economics: Inter-Koreas Pact is Seen as Light on Substance*, WALL ST. J., Oct. 5, 2007, at A8 (noting that while a cease fire stopped the 1950-1953 war, North and South Korea have only recently resumed discussions regarding a peace treaty that would formally end the war).

²⁵⁴ *C.F. Mueller v. Comm’r*, 190 F.2d 120, 121 (3d Cir. 1951).

²⁵⁵ *Id.* at 123.

²⁵⁶ FISHMAN & SCHWARZ, *supra* note 31, at 377 (quoting Rep. John Dingell’s remarks during hearings before the House Committee on Ways and Means).

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that unfair competition would be a major problem in the absence of UBIT,²⁵⁷ the historical record indicates there were few complaints from for-profit businesses about unfair competition at the time of its enactment,²⁵⁸ and some have asserted that UBIT even *fosters* unfair competition.²⁵⁹

Even if unfair competition were a viable justification for UBIT, it certainly would not be a justification to extend UBIT to cover college and university endowment income. Passive investing done by endowments, unlike the conduct of an active business, simply does not raise unfair competition concerns.²⁶⁰

B. Efficiency

Henry Hansmann, in addition to his work on endowments and the capital subsidy theory (discussed above), has also set forth a theory of UBIT based on economic efficiency.²⁶¹ Under this theory, UBIT helps prevent inefficiencies at nonprofits.²⁶² First, UBIT encourages nonprofits to diversify their investments.²⁶³ UBIT encourages nonprofits to invest in a broad range of common stocks (which generate income exempt from UBIT) rather than investing in a few, wholly-owned businesses (subject to

²⁵⁷ See Bittker & Rahdert, *supra* note 230, at 318-20.

²⁵⁸ Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1510 (2005).

²⁵⁹ Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1038 (1982). The idea is that nonprofits, because of UBIT, will concentrate their efforts on businesses that are related to their exempt mission (and thus not taxed by UBIT). *Id.* The effect is to concentrate nonprofit businesses in certain markets, hurting for-profit businesses competing in those markets. *Id.*

²⁶⁰ Since unfair competition was the given reason for the enactment of UBIT, it makes sense that UBIT excludes most passive/investment-type income. See *supra* Part II.C.1.

²⁶¹ Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989).

²⁶² *Id.* at 614.

²⁶³ *Id.*

UBIT).²⁶⁴ In the absence of UBIT, nonprofits may switch from diversified stock portfolios to wholly owned businesses.²⁶⁵ For those nonprofits that can only afford to invest in a few businesses, there would be little diversification—thus increasing investment risk.²⁶⁶ Nonprofits with the resources to own several businesses in diverse industries would essentially become conglomerates—a structure ripe with inefficiencies.²⁶⁷

Second, a tax exemption for the unrelated businesses of nonprofits, in Hansmann’s view, would be an inefficient government subsidy.²⁶⁸ In the absence of UBIT, nonprofits would not use their extra resources (i.e., the tax savings) to under-price their for-profit competitors.²⁶⁹ Instead, with no shareholders to be accountable to, nonprofits would keep their prices the same as their for-profit competitors and would spend the tax savings on inefficient operations.²⁷⁰ The government subsidy would therefore be wasted.²⁷¹ UBIT thus serves to prevent a wasted subsidy.

Third, Hansmann believes that, in the absence of UBIT, nonprofits would be encouraged to invest in unrelated businesses.²⁷² This, in turn, would encourage them to save rather than spend.²⁷³ Hansmann cites endowment accumulation as evidence that nonprofits are already pre-disposed to over-save.²⁷⁴ A repeal of UBIT would only serve

²⁶⁴ *Id.* at 614-15.

²⁶⁵ *Id.* at 615.

²⁶⁶ *Id.*

²⁶⁷ *Id.* at 617.

²⁶⁸ *Id.* at 616.

²⁶⁹ *Id.*

²⁷⁰ *Id.*

²⁷¹ *Id.*

²⁷² *Id.* at 618-19.

²⁷³ *Id.*

²⁷⁴ *Id.* at 620.

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to encourage even more saving behavior. In a UBIT-free world, colleges and universities would spend even less and accumulate even more.²⁷⁵

Hansmann's efficiency theory would not seem to support the extension of UBIT to cover endowment income. Regarding his point about diversification, endowment income clearly should not be taxed. If endowment income were subject to UBIT, colleges and universities would no longer be encouraged to have diversified equity portfolios. In a world where both business income and passive investment income were subject to tax, endowments would invest in wholly owned businesses if they could get a higher return. Assuming that is the case, endowments would invest in a few operating business rather than in a range of stocks. This would either stifle diversification or lead to conglomeration—two results Hansmann views as inefficient.

Hansmann's point about the tax subsidy for unrelated businesses being absorbed by inefficient operations provides no basis for taxing endowment income. Endowment income is made from passive investments and, for the most part, the impressive returns indicate that the portfolios are being managed efficiently.

Hansmann's last point, that UBIT helps prevent inefficient over-saving, may appear to support a tax on endowment income. Since UBIT discourages savings via unrelated businesses, extension of UBIT to endowment income should further discourage savings by organizations (such as colleges and universities) already predisposed to over-saving. However, Hansmann does not argue that UBIT be extended to further dampen savings; he merely states that repeal of UBIT would further exacerbate any preexisting

²⁷⁵ *Id.*

over-saving problem.²⁷⁶ Further, in his subsequent work on endowments, discussed above, Hansmann came out against government *regulation* of endowment accumulation policies and noted that any inefficiencies/waste created by over-accumulation is likely to be minimal.²⁷⁷ Presumably, a similar argument can be made against using a *tax* (such as UBIT) to dampen spending tendencies.

C. Threats to Sovereignty

Evelyn Brody developed the theory that UBIT (and other limitations on tax exemption) are designed to limit the power of organizations that have been granted tax exempt status²⁷⁸ Nonprofits operate as independent “sovereigns” according to this theory.²⁷⁹ The true sovereign, the federal government, grants nonprofits this independence and sovereignty through tax exemption but limits it through devices such as UBIT to keep nonprofits from gaining too much property and power: “underlying some of the more perplexing rules limiting the scope of exemption [e.g., UBIT] is an unarticulated vestigial fear of a too-powerful nonprofit sector, traceable to earlier periods when the most powerful charity was the church.”²⁸⁰

If college and university endowments were considered too large (and thus conferring too much power on the schools), then the extension of UBIT to tax endowment income would be consistent with the sovereignty theory. While Brody

²⁷⁶ *See id.*

²⁷⁷ Hansmann, *Endowments*, *supra* note 14, at 40. See *supra* Part III.C for a detailed discussion of Hansmann’s article on endowments.

²⁷⁸ Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998).

²⁷⁹ *Id.* at 586-87.

²⁸⁰ *Id.* at 629. Indeed, Brody notes historic limitations on church power, such as Henry VIII’s seizure of monasteries in England and Mexico’s laws against church-ownership of property (not repealed until 1992). *Id.* at 586 n. 2.

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identifies sovereignty as an explanation for UBIT, however, she does not advocate its continued use.²⁸¹ In fact, she urges policymakers to “resist the lures” of the sovereignty approach and to consider broader reforms of the tax treatment of charities.²⁸²

D. The “Old Line”/Political Function Theory

Ethan Stone has advanced the theory that UBIT exists to encourage nonprofits to avoid activities that are politically embarrassing.²⁸³ UBIT, in general, taxes activities that are considered unseemly while not taxing items considered the proper province of the nonprofit sector. Stone concludes:

The UBIT was designed to channel charities away from problematic activities by setting up a tax gradient that favored income-generated activities compatible with perceptions of charitable activity. At the taxable end were highly visible activities that challenged perceptions of charitable activities—active business endeavors unrelated to any charitable purpose. Law schools that wanted to make Congress uncomfortable by running spaghetti and piston-ring factories would have to pay for the privilege. At the exempt end were activities more compatible with perceptions of charitable activity—traditional, passive investment and active business endeavors related to accomplishing a charitable objective. Charities willing to “adhere to the old line” of good works and passive investment were rewarded.²⁸⁴

Stone’s theory comes right out and explains why passive income is not subject to UBIT. Nonetheless, if college and university endowments become so large that they pose a political problem, then it appears that the political function theory may call for the extension of UBIT to endowment income. While some have raised concerns (namely the Senate Committee on Finance) about endowments, it does not appear that we have

²⁸¹ *Id.* at 587.

²⁸² *Id.*

²⁸³ See Stone, *supra* note 258, at 1479-80.

²⁸⁴ *Id.* at 1554.

reached the point where endowments (and their returns) have become as politically problematic as investments in noodle companies. Accordingly, the political function theory does not currently support the extension of UBIT to endowment income.

E. Summary

In summary, the various theories for the rationale underlying UBIT reviewed here do not support taxing endowment income. Unfair competition is likely not a good rationale to explain UBIT and, even if it were, endowment investments simply do not raise unfair competition concerns. Hansmann's efficiency theory raises concerns about over-saving (as may be occurring in endowments) but does not necessarily call for endowment income to be taxed. In fact, much of his theory would counsel against it. Brody's sovereignty theory may call for UBIT to apply to endowment income as a check on the property and power being accumulated by colleges and universities. Brody herself, however, does not think the sovereignty theory should guide policy. Finally, Stone's political function theory clearly rules out taxing endowment income, at least at present.

VI. PRIVATE FOUNDATIONS

The previous Part reviewed the rationales underlying UBIT to determine if they would justify taxing income from college and university endowments. This Part examines the rationales underlying the relevant parts of the private foundation rules to determine whether these rules should be extended to impose a minimum distribution requirement on college and university endowments.

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A. Overview of Private Foundation Rules

Colloquially, a private foundation is a section 501(c)(3) organization that derives the bulk of its support from limited sources—normally a wealthy family or a corporation.²⁸⁵ While some private foundations actually run charities themselves, many simply make grants to other charitable organizations, which carry out the actual charitable work.²⁸⁶ Technically, all section 501(c)(3) organizations are considered private foundations unless they meet one of the enumerated exceptions to such status.²⁸⁷ Colleges and universities, regardless of the source of their funds, are not classified as private foundations.²⁸⁸ Likewise, organizations supporting public colleges and universities²⁸⁹ are normally exempt from private foundation status as well.²⁹⁰

Section 501(c)(3) organizations that are classified as private foundations are subject to a litany of requirements in addition to the normal rules governing tax exempt organizations (reviewed above in Part II). For example, private foundations are subject

²⁸⁵ FISHMAN & SCHWARZ, *supra* note 31, at 510. Note that whether or not an organization has “foundation” in its name is of no consequence. Many nonprofits use “foundation” in their name but are not subject to the private foundation rules.

²⁸⁶ The former are known as “operating foundations” and are subject to a slightly less onerous tax regime. For example, an operating foundation is not subject to the minimum distribution requirements of I.R.C. § 4942.

²⁸⁷ I.R.C. § 509.

²⁸⁸ I.R.C. § 509(a)(1) (indicating that an organization described in I.R.C. § 170(b)(1)(A) will not be considered a private foundation); I.R.C. § 170(b)(1)(A)(ii) (referring to “an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on”—a definition which obviously applies to the typical college or university).

²⁸⁹ See discussion at *supra* note 20 and accompanying text.

²⁹⁰ I.R.C. § 509(a)(1) (indicating that an organization described in I.R.C. § 170(b)(1)(A) will not be considered a private foundation); I.R.C. § 170(b)(1)(A)(iv) (referring to an organization with substantial public support “which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university . . . and which is an agency or instrumentality of a State. . .”). Such organizations are commonly referred to as “supporting organizations.” Provided these organizations meet the requisite public support test, they will not be classified as private foundations.

to a one or two percent tax on their net investment income,²⁹¹ are prohibited from entering into certain transactions with foundation officers (self-dealing),²⁹² are required to make minimum distributions to charity (discussed further below),²⁹³ cannot own more than a specified percentage of their principal donor's business,²⁹⁴ are subject to prudent investments requirements,²⁹⁵ and are prohibited from making any lobbying or political campaign expenditures.²⁹⁶ These requirements are backed up by a series of excise taxes which seek to punish noncompliance.²⁹⁷

The most relevant private foundation rule for present purposes is the minimum distribution requirement.²⁹⁸ It is this requirement that Congress may consider extending to college and university endowments. Stripped of unnecessary detail, private foundations are required to spend at least 5% of the net fair market value of their assets (other than assets used to carry out charitable activities) on charitable purposes.²⁹⁹ Failure to distribute the required amount by the end of the year following the taxable year triggers excise taxes. The initial excise tax is equal to 30% of the undistributed amount.³⁰⁰ This tax continues to apply each year to any of the required distribution

²⁹¹ I.R.C. § 4940.

²⁹² I.R.C. § 4941. For example, a foundation cannot loan money to an officer. I.R.C. § 4941(d)(1)(B).

²⁹³ I.R.C. § 4942.

²⁹⁴ I.R.C. § 4943.

²⁹⁵ I.R.C. § 4944.

²⁹⁶ I.R.C. § 4945.

²⁹⁷ I.R.C. §§ 4941-4945. In addition, the charitable deduction for donations to private foundations is subject to stricter percentage limits. *See* I.R.C. § 170(b)(1)(B) & (D). The details are not particularly relevant for purposes of this Article.

²⁹⁸ I.R.C. § 4942. Private foundations that do more than simply make grants—i.e., those that meet the requirements to be considered “operating foundations”—are not subject to the minimum distribution rules I.R.C. § 4942(a)(1) & (j). It would seem quite odd for Congress to exempt operating foundations and yet impose the minimum distribution requirements on colleges and universities—which are not even considered private foundations under the law.

²⁹⁹ I.R.C. § 4942(e)(1). The 5% is called the “minimum investment return.” *Id*

³⁰⁰ I.R.C. § 4942(a).

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amount that remains undistributed.³⁰¹ If any part of the required distribution continues not to be made, a second tier tax of 100% of the undistributed amount will apply.³⁰²

Note that the 5% distribution requirement is currently greater than the average 4.6% spending rate currently used by college and university endowments.³⁰³ While this may not seem like a big difference, given the amounts involved (in the billions in some cases), the absolute dollar amount of additional distributions that would be required could be significant.³⁰⁴

B. Rationales for Private Foundation Rules

Leading commentators have been unsuccessful at finding a clear, reasonable rationale for the higher level of regulation imposed on private foundations.³⁰⁵ Much of the regulation, originally imposed in the Tax Reform Act of 1969, was targeted at specific organizations because of specific abuses or for political reasons.³⁰⁶

The only plausible overall justification for increased regulation of private foundations is their lack of accountability. A major study of foundations put it this way:

A major cause of the various sins committed by foundations—arrogance, discourtesy, inaccessibility, and the others—is their lack of accountability. Most other institutions in America, whether in the civic sector, the for-

³⁰¹ *Id.*

³⁰² I.R.C. § 4942(b). This tax will apply if the required distribution remains unpaid at the end of the “taxable period,” as defined in I.R.C. § 4942(j)(1) (generally, the “taxable period” ends on the date the IRS mails a notice of deficiency with respect to the 30% initial tax).

³⁰³ See *supra* note 7.

³⁰⁴ Goldie Blumenstyk, *Pressure Builds on Wealthy Colleges to Spend More of Their Assets*, CHRON. HIGHER ED., Oct. 26, 2007.

³⁰⁵ Bittker & Rahdert, *supra* note 230, at 341 (indicating that a search for a rationale for the special rules on private foundations “is not likely to be fruitful”). Bittker and Rahdert specifically criticize the excise tax on investment income in I.R.C. § 4940. Billed as a “user charge” to cover the cost of auditing private foundations, it bore no relation to concepts of net income and effectively taxed grants rather than the foundation itself. *Id.* at 326-28. Further, there was really no justification for charging private foundations, but not other nonprofit enterprises, for the audit costs incurred by the government. *Id.* at 327.

³⁰⁶ See *id.* at 338, 341.

profit sector, or government, benefit from continuing challenges, criticism, and oversight provided by others to whom they are accountable.³⁰⁷

Many private foundations received their funding from one source—an individual, a family, or a corporation—in perpetuity.³⁰⁸ Once the principal donors have left, private foundations have few constituencies that are privy to their finances and operations, and can thus get by with doing very little in the way of “charitable” work.³⁰⁹ Therefore, it might make sense for the federal government to more heavily regulate private foundations to ensure they at least engage in a minimum level of charitable work.

The counterargument to the “lack-of-accountability” rationale is that the government is regulating private foundations for less noble purposes. If private foundations were free of government control (save for the rules that apply to regular public charities), they would be free to experiment. This could lead to problems with politicians: “Private organizations displaying independence, flexibility, and originality are bound to tread on toes, and when the toes belong to public officials, an adverse legislative reaction should not come as a surprise.”³¹⁰ Accordingly, private foundations end up contending with a more onerous regulatory regime.

Whatever the virtues of the private foundation regime, commentators have strongly cautioned against its extension to police against other real or perceived abuses by public charities:

It is common knowledge that preachers sometimes divert church funds to personal ends, that the nonprofit façade of a school or college can mask a proprietary operation, that some hospitals serve primarily to enrich their

³⁰⁷ JOEL L. FLEISHMAN, *THE FOUNDATION: A GREAT AMERICAN SECRET* 153 (2007).

³⁰⁸ FISHMAN & SCHWARZ, *supra* note 31, at 510.

³⁰⁹ Anecdotal evidence of private foundations accumulating income and ignoring their charitable purpose led to some of the reforms, such as the minimum distribution requirement. *Id.* at 608. It is unclear exactly how wide-spread this problem actually was. *See id.*

³¹⁰ Bittker & Rahdert, *supra* note 230, at 342. See also *supra* Part V.C regarding Brody’s rationale for UBIT, which invokes similar issues.

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physician-entrepreneurs, and that some publicly supported charities allow most of their contributions to be siphoned off by grasping fundraisers. It is equally clear, however, that these instances did not—and should not—impel Congress to extend to the vast body of charitable organizations the labyrinth of statutory restrictions, navigable only by lawyers and accountants and guarded by penalties far exceeding the civil penalties for deliberate tax fraud, which were prescribed in 1969 for private foundations.³¹¹

By the same rationale, the fact that some institutions may be erring on the side of investing rather than spending endowment earnings should not justify the extension of private foundation-type rules to colleges and universities.

C. Differences Between Private Foundations and Colleges and Universities

Extension of private foundation-type rules—such as a minimum distribution requirement—to colleges and universities has been proposed before.³¹² However, the perceived abuses at private foundations—due to their insular nature and lack of transparency and accountability—that perhaps warrant the minimum distribution requirement simply are not present in the college and university environment. In contrast to private foundations, colleges and universities must answer to various active and vocal

³¹¹ Bittker & Rahdert, *supra* note 230, at 341-42.

³¹² The Filer Commission (a 1970s study of nonprofit groups) suggested in 1977 that the 5 percent of investment asset distribution requirement that applies to private foundations be extended to all nonprofits with endowments (including colleges and universities). Hansmann, *Endowments, supra* note 14, at 6 (citing Commission on Private Philanthropy and Public Needs (the Filer Commission), Research Papers 28-30 (1977)). Germany and Canada have experimented with minimum distribution requirements. Hansmann, *Endowments, supra* note 14, at 6. Both countries initially enacted restrictive payout rules and then later liberalized them. *See id.* Further discussion of international policy towards endowments is beyond the scope of this Article. Instead, this Article focuses on whether restrictions on endowment accumulation make sense in light of the underlying rationales for the tax exempt rules that have traditionally applied in the U.S.

constituencies. Colleges and universities have pointed this out³¹³ and there is ample evidence to back up their assertions.

Colleges and universities must be responsive to concerns of students, faculty, staff, alumni, and the surrounding community. Such groups are rarely shy about expressing their views. Colleges and universities are also subject to review by private accreditation agencies, both at the institutional and individual program levels.³¹⁴ Further, they must comply with a litany of federal guidelines to ensure that their students can receive federal financial aid.³¹⁵

College and universities, unlike private foundations, have miniature-cities to run. They must deal with a work force and physical facilities that require a long-term, sustained commitment that the endowment can help support.³¹⁶ Private foundations have no such commitments. They may have a small office and staff, but could likely liquidate their endowments in a short period of time without much consequence.³¹⁷

Public colleges and universities, moreover, are subject to state control and are often answerable to a diverse governing board made up, often, of elected and appointed

³¹³ Higher Education Associations Testimony, *supra* note 10.

³¹⁴ *See, e.g.*, KAPLIN & LEE, *supra* note 18, at 1530-34.

³¹⁵ Patricia J. Gumpert & Stuart K. Snyderman, *Higher Education: Evolving Forms and Emerging Markets*, in *THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK* 462, 467 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006). Federal funding for higher education tends to take the form of aid provided to students, rather than direct support to colleges and universities. *Id.* Despite the compliance costs involved, “[c]olleges and universities of all types have an enormous incentive to become and remain eligible for student financial aid programs” *Id.*

³¹⁶ Blumenstyk, *supra* note 304 (noting that “Washington University employees more than 13,000 people and operates more than 150 buildings on its main campus, medical center complex, and surrounding sites”).

³¹⁷ Despite the hardship that would come with summarily liquidating an endowed college or university, at least one commentator has suggested (in jest?) that some high profile Ivy League schools do just that. Thomas Bartlett, *Yanking (the Chains of) the Ivies*, *CHRON. HIGHER ED.*, Oct. 26, 2007. Author Malcolm Gladwell recently made this suggestion because, in his view, Ivy League schools don’t do a good job of promoting social mobility. *Id.* *The Chronicle of Higher Education* painted an interesting picture of the proposed liquidations: “Their campuses turned into luxury condos. Their students distributed evenly throughout the colleges of the Big Ten. Their endowments donated to charity, or used to purchase Canada.” *Id.*

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members.³¹⁸ Private colleges and universities tend to be more private foundation-like in their governance structures, using closed proceedings and governing boards whose new members are chosen by current members and the school's administration.³¹⁹

Nonetheless, concerned alumni will not hesitate to raise their voices to criticize board decisions or to weigh in on important issues of institutional governance or mission. A recent controversy over board membership and governance issues at Dartmouth is evidence of this.³²⁰ In fact, entire books have been written criticizing private institutions and their governance.³²¹ Such criticism is not nearly as common in the private foundation world.

Finally, and perhaps most importantly, the higher education community is subject to the scrutiny of donors and potential donors. Colleges and universities, unlike private foundations, must raise money. Despite having large endowments, institutions continue to fundraise, which makes them subject to prospective donor scrutiny.³²² While fundraising has always been important for private institutions, it is increasingly becoming

³¹⁸ Gumpert & Snyderman, *supra* note 315, at 471. Endowments of public institutions, as explained at *supra* note 20, are often housed in separate supporting organizations. These separate organizations are designed to be outside of state restrictions, but there may be issues regarding just how legally independent from the state these organizations truly are. See, e.g., KAPLIN & LEE, *supra* note 18, at 241-49. These legal complexities aside, the supporting organizations are at least partially answerable to the school's administration, which, in turn, is answerable to the state. It is not unreasonable to assume that a state governing board would consider the level of private giving (evidenced by the endowment) in making decisions regarding the school.

³¹⁹ Gumpert & Snyderman, *supra* note 315, at 471.

³²⁰ Joseph Rago, *The Weekend Interview with T.J. Rogers: Mr. Rogers Goes to Dartmouth*, WALL ST. J., Sept. 1, 2007, at A7 (reporting how new trustees at Dartmouth, elected by the alumni, are shaking up the normally staid board by demanding action on several issues including enhancing academic freedom and the hiring of more professors).

³²¹ E.g., BUCKLEY, *supra* note 183 (criticizing Yale University's governance structure and its deviation from its historic mission).

³²² See, e.g., Zachery M. Seward, *Rich Alumni Stiff Elite Alma Maters, Give to Needier Colleges*, WALL ST. J., Aug. 28, 2007, at B1 (indicating that even Harvard, which has the largest endowment, continues to solicit donations). Based on this fact, there is little evidence that institutions are using endowment accumulation to insulate themselves from outside demands. See *supra* Part III.C.6 for discussion of Hansmann's concern over this issue.

important for public institutions as well.³²³ Colleges and universities must be accountable to current and potential donors in their stewardship of current and future gifts. Capital campaigns, for example, have become the nonprofit analog of the initial public offering. A college or university undertaking a capital campaign, much like a company contemplating an IPO, must develop a strategic plan, identify its unmet needs (a new building, more scholarships, more graduate programs, endowed professorships, etc.), and sell the merits of fulfilling those needs to prospective donors.³²⁴ In short, the institution must be accountable in order to raise funds.

The accountability and transparency necessary to attract funds puts pressure on colleges and universities to better monitor their endowment accumulation policies. A large endowment, for example, may encourage potential donors to give elsewhere—where their money is more urgently needed.³²⁵ In fact, some universities have found that they need to address endowment size in soliciting new gifts. Harvard, for example, tells prospective donors that many areas of the university remain unsupported by its endowment and that it continues to need additional funds.³²⁶

³²³ Gumport & Snyder, *supra* note 315, at 467 (noting that public colleges and universities have gone from “state-supported” to “state-assisted” and now, according to some, to merely “state-located”). See also *supra* note 20 for further discussion of state school fundraising.

³²⁴ See, e.g. Destination Distinction: The Campaign for Boise State University, at <http://www.boisestate.edu/foundation/campaign/index.html> (detailing the school’s recently-launched \$175 million capital campaign and explaining the specific needs—scholarships, professorships, facilities, etc.—for which the money is being raised). Boise State’s capital campaign goal (\$175 million) is relatively modest. There are currently 31 colleges or universities that are each attempting to raise \$1 billion or more via capital campaigns. Marisa Lopez-Rivera, *Updates on Billion-Dollar Campaigns at 31 Universities*, CHRON.HIGHER ED., Jan. 9, 2008.

³²⁵ See, e.g., Seward, *supra* note 322 (profiling “a rising cohort of philanthropists who are eschewing their richly endowed alma maters in favor of schools with meager resources”). Note, however, that many give to their alma maters out of a sense of emotional attachment or a need to feel they are “giving back.” Therefore, it might not be so easy for a donor to take funds intended for his alma mater and give them to some other institution with which he has little connection. See Hansmann, *Endowments*, *supra* note 14, at 35.

³²⁶ Seward, *supra* note 322.

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As colleges and universities solicit funds, they may find that a new trend in philanthropy stifles attempts at growing endowments. Modern philanthropists such as Warren Buffet, for example, seem determined to see their charitable gifts spent currently, rather than endowed in a perpetual foundation.³²⁷

In summary, donors play a strong role in regulating college and university behavior—including their approach to endowments. It is this sort of outside scrutiny that is lacking in private foundations.

All in all, many diverse groups scrutinize the conduct of colleges and universities and prevent such institutions from becoming insular. Colleges and universities and private foundations may, at first glance, appear similar because of their substantial endowments. In fact, they are two very different types of institutions. Accordingly, they should not be taxed and regulated as if they were the same.

VII. CONCLUSION

Five themes emerge from our review of the tax law of higher education and the literature that attempts to explain that law. First, education is not synonymous with charity. A college or university is entitled to tax exemption because it educates, not because it helps the less fortunate. The education colleges and universities provide is of sufficient societal benefit to warrant the tax exemption.

Second, one of the hallmarks of tax exemption is the provision of a government subsidy without government control. Colleges and universities, dedicated to the exempt

³²⁷ Stephanie Strom, *Big Gifts, Tax Breaks, and a Debate on Charity*, N.Y. TIMES, Sept. 6, 2007 (indicating that Warren Buffet's gifts to the Bill and Melinda Gates Foundation are to be spent within a year of receipt).

function of education, should be left to carry out their missions free from interference from the federal government. Inefficiencies and failures (such as the over-accumulation of endowments) may result, but they are tolerated to promote the loftier goals of fostering freedom, independence, and flexibility in the nonprofit sector.

Third, past instances of the federal government extending its taxing or regulatory reach into the nonprofit world—such as via the UBIT regime or the private foundation rules—have not been based on solid reasoning. The rationales that scholars have been able to find for these rules would not support extension of these regimes to endowments. In fact, extension of these regimes into the endowment world would be contrary to many of the rationales articulated to date.

Fourth, even one of the most vocal critics of endowment policy, Henry Hansmann, advises against regulation of endowment income. He reached this conclusion after an exhaustive study and critique of endowment policies in higher education.

Fifth, the private foundation rules, whatever their merit, simply do not import well into the college and university community. Colleges and universities, unlike private foundations, are accountable to a broad range of constituents. There is little benefit to adding a minimum distribution requirement to the list of the forces already guiding higher education behavior.

The existing literature on endowment management, the rationales for tax exemption, the justifications for UBIT, and the law of private foundations provide little justification for taxing or regulating endowment income. While some schools may well be hoarding their endowment earnings, there is not a strong theoretical case for imposing a tax or minimum distribution requirement on endowments. Hopefully, the Senate

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Committee on Finance's work to date and the specter of congressional action will prompt any institutions spending their endowments in less than optimal ways to rethink their strategies. In fact, there is some evidence that this is occurring. Both Harvard and Yale have recently announced that they would tap into their endowments to significantly expand aid programs for students from middle income families.³²⁸ A few other institutions have also announced increased endowment spending on financial aid.³²⁹ It remains to be seen whether these moves will induce even more institutions with large endowments to rethink their spending policies.

In addition to the threat of congressional action, increased transparency requirements may also influence endowment policies. The IRS and the Financial Accounting Standards Board (FASB) have recently announced they may be requiring colleges and universities to disclose more details about their endowments and spending policies.³³⁰ These additional disclosure requirements could pressure colleges and universities to better monitor their endowment policies.

³²⁸ See Eric Hoover, *Yale Follows Harvard in Announcing Big Student-Aid Jump*, CHRON. HIGHER ED., Jan. 15, 2008. Yale's annual financial aid budget will increase from \$24 million to \$80 million under the new plan. *Id.* Yale officials admitted that the recent focus on endowments by lawmakers was one factor (among others) that led to the new program. *Id.* In addition, Yale has re-calibrated its endowment spending policy—now targeting a minimum payout rate of 4.5% and a maximum payout rate of 6%. Press Release, Yale to Increase Endowment Payout to Expand Access and Advance Science (Jan. 7, 2008) at <http://www.yale.edu/opa/newsr/08-01-07-01.all.html>. Under Harvard's plan, its annual financial aid budget will increase from \$98 million to \$120 million. See John Hechinger, *Harvard Trims Tuition Bills for Families*, WALL ST. J., Dec. 11, 2007, at B17.

³²⁹ See Anne Marie Chaker, *Some Colleges Cut, Eliminate Debt*, WALL ST. J., Nov. 29, 2007, at D1 (describing how several institutions, such as Williams and Stanford, are tapping their endowments to expand aid). Some fear that increased spending by wealthier, elite institutions will make it even more difficult for other ("non-elite") institutions to compete for students—escalating what has been dubbed "the academic arms race." Goldie Blumenstyk, *Colleges' Endowments-Spending Prerogatives Get Unexpected Defense*, CHRON. HIGHER ED., Feb. 4, 2008. This concern also argues against forcing colleges and universities to increase spending from their endowments.

³³⁰ The IRS has announced that colleges and universities will need to report the value of their endowments on Form 990. Goldie Blumenstyk, *IRS Issues Final Version of Tax Form for Colleges and Other Nonprofit Groups*, CHRON. HIGHER ED., Dec. 21, 2007. The IRS has also announced that it will begin a college and

If a tax or minimum distribution requirement were to be imposed on endowments, we would be casting aside our traditional (and current) understanding of how nonprofits should be taxed and regulated. Casting aside these understandings, however, would require a fundamental re-imagining of the nonprofit sector—that would go well beyond the relatively narrow issue of endowments. If we embarked on such a task, it would require we rethink our notions of “charity”³³¹ and “education,” our allowance of charitable gifts with perpetual restrictions, and the appropriate bounds of government regulation of the nonprofit sector. Perhaps someday we will accomplish this task, and can revisit endowments in light of our new understanding of the broader nonprofit universe. Until that day, Congress should avoid piecemeal reforms and follow the lesson taught by our tour of the nonprofit literature: that the fruit that is endowment income is not only low-hanging; it is also forbidden.

university compliance initiative in 2008 that will involve sending questionnaires to higher education institutions. Christopher Quay, *EO's 2008 Workplan Focuses on Universities, Non-501(c)(3) Orgs*, TAX NOTES TODAY, Dec. 14, 2007, at 241-6. Among many other topics, the questionnaires will ask how the colleges and universities are using their endowments. *Id.* FASB has announced that they are moving forward with new disclosure requirements on endowments, including disclosures on endowment spending policy and planned endowment distributions. Carolyn Wright LaFon, *FASB Moves Forward on New Disclosures for Nonprofit Endowments*, FINANCIAL REPORTING WATCH, Jan. 9, 2008, at 6-7.

³³¹ Such a rethinking may be going on currently in the United Kingdom. Under the Charities Act 2006, private schools can have their tax exemptions revoked unless they can demonstrate that they are providing a benefit to the public. *See* Polly Curtis & David Brindle, *Do More For Poorer Children or Lose Your Charitable Status, Private Schools Are Told*, GUARDIAN, Jan. 16, 2008, available at <http://www.guardian.co.uk/society/2008/jan/16/voluntarysector.schools>. To retain tax exemption, a school must do more than educate—it must also show it is not an “exclusive club for the rich” and that it benefits low income students. *Id.*