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Abstract

The Tax Cuts and Jobs Act of 2017 introduced the first-ever excise tax imposed on the investment income of university endowments. While it is a relatively small tax, this new law is a first step towards the exploration of taxing non-profit entities on the vast sums of wealth they hold in their endowments. In this essay I take the new tax as a starting place for investigating the justification for tax exemption for universities and thinking through the consequences of changing our approach, both in the form of the new excise tax and possible alternatives. There remain reasons to be skeptical both about the design of the current tax and its ability to withstand the political efforts of the powerful set of universities who will be subject to it. Nonetheless, this new tax opens the door to a discussion of whether it is time to treat universities' endowments more like the private equity funds they increasingly resemble.

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I. INTRODUCTION

Much of the attention paid to the so-called Tax Cuts and Jobs Act[1] (TCJA) focused on the significant cut in the tax rate assessed to corporations,[2] the creation of a deduction for non-corporate business income under the new § 199A,[3] the elimination of a variety of tax benefits aimed at relatively lower income taxpayers,[4] and the changes to the international tax regime.[5] However, one change to the tax code created under this bill focused in another direction entirely, attempting, for the first time, to tax university endowments.[6]

The justification for this new excise tax stems from a claim that the increasing size of these endowments, and the growing disconnect between the endowment itself and the charitable purpose of the institution (namely, the education of students and the promotion and support of research and service), requires finding ways to encourage universities to think differently about their endowments. The original justifications for allowing non-profit entities, including universities, to earn income, including investment income, without subjecting those earnings to federal income taxation, lose some of their weight in the face of hundred-billion-dollar endowments. Indeed, many lawmakers

1. *See* Jennifer Bird-Pollan, *Revising the Tax Law: The TCJA and Its Place in the History of Tax Reform*, 45 OHIO N.U. L. REV. 501, 508 n.69 (2019) (showing that the Tax Cuts and Jobs Act was codified under scattered sections of the United States Code). While the tax bill of 2017 is regularly referred to as the "Tax Cuts and Jobs Act," the bill has no official title. *Id.* at 501.

2. Nicholas H. Cohen & Manoj Viswanathan, *Corporate Behavior and the Tax Cuts and Jobs Act*, U. CHI. L. REV. ONLINE *1 (Apr. 2, 2020), https://lawreviewblog.uchicago.edu/2020/04/02/corporate-behavior-and-tcja-cohen-viswanathan/.

3. *See* James R. Repetti, *The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity*, 21 FLA. TAX REV. 686, 690–95 (2018); *see also* Andrew Snyder, *The Lawyer, the Engineer, and the Gigger: § 199A Framed as an Equitable Deduction for Middle-Class Business Owners and Gig Economy Workers*, 25 FORDHAM J. CORP. & FIN. L. 615, 616–19 (2020).

4. Erin Huffer et al., *Effects of the Tax Cuts and Jobs Act on State Individual Income Taxes*, 58 WASH. U. J.L. & POL'Y 205, 209–10 (2019).

5. Rebecca Rosenberg, *More Generous Than Accurate: The Gilti Foreign Tax Credit and Coordination of the Foreign Tax Credit Rules with the New International Tax Provisions of the TCJA*, 83 ALB. L. REV. 339, 341–45 (2019).

6. *See generally* Mae C. Quinn, *Wealth Accumulation at Elite Colleges, Endowment Taxation, and the Unlikely Story of how Donald Trump Got One Thing Right*, 54 WAKE FOREST L. REV. 451 (2019).

> [T]he TCJA enacted an excise tax on the net investment income of certain private colleges and universities. The tax applies not only to interest and dividends, but also to royalties. The new tax may have the effect of reducing the value of endowments and redirecting money that could be used for basic research from those institutions to the federal government.

Xuan-Thao Nguyen & Jeffrey A. Maine, *Attacking Innovation*, 99 B.U. L. REV. 1687, 1746 (2019).

and scholars believe that the growing concentration of wealth in the hands of the richest universities demands a response. While the central drivers of the creation of the 2017 tax bill and the university endowment excise tax included in it were conservative lawmakers who saw the increasing wealth of colleges and universities (often characterized as liberal strongholds) as problematic, there are reasons to believe that the accumulation of wealth in university endowments is an issue that should alarm policymakers on both sides of the political aisle. This essay will lay out the history of the income tax exemptions applicable to university endowments, evaluate the justification for and effectiveness of the new excise tax, and compare this approach to other models aimed at reducing the accumulation of wealth in university endowments—in particular, an elimination of the income tax exemption for universities' investment income. The essay proceeds as follows: Part II explains the current operation of the income tax exemption for non-profit entities, as well as the rationale for that exemption; Part III identifies objections to that exemption model; Part IV focuses on some of the problems particular to higher education institutions; Part V explains the new excise tax; Part VI explores alternate models for taxing university endowments; and Part VII concludes.

II. THE INCOME TAX EXEMPTION FOR NON-PROFIT ORGANIZATIONS

Following in the traditions of our common law predecessors in the English legal tradition, the United States federal income tax has included an exemption for income earned by charitable entities since the beginning.[7] The original arguments for this exemption stem from the belief that the charitable work provided by certain entities substitutes for activity that would otherwise have to be funded and performed by the government.[8] Allowing and encouraging charitable entities to engage in this work reduces the necessity for it to be done by the government. Therefore, so the argument goes, a subsidy provided by the federal government for entities so engaged is entirely appropriate.[9]

7. *See generally* Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 511–513 (2010) (giving a history of the tax exemption of charitable entities through the years, both inside the United States and beyond).

8. *See id.* at 512–13 (noting that the modern American tax exemption usually derives from "community benefit," but that the concept of a "community benefit" is still vague).

9. *See id.* at 513.

Non-profit organizations recognized as charitable entities organized in the United States and recognized under Internal Revenue Code § 501(c)(3) are actually entitled to two separate and distinct federal tax benefits. First, charitable entities are eligible for exemption from the federal income tax under § 501.[10] This tax exemption benefit is distinct from the second tax benefit, a charitable contribution deduction under § 170, which operates by reducing the taxable income of individuals who make charitable contributions to certain non-profit entities.[11] Significant scholarly efforts have focused on the charitable deduction and the design, enforcement, and evaluation of that provision.[12] In addition, the charitable contribution deduction looms large in the public imagination about tax law.[13] However, the exemption from the income tax is a broader provision than the charitable contribution deduction, providing a tax benefit to a wider group of entities than are eligible to receive tax-deductible contributions.[14] Included in the category of tax-exempt entities are the vast majority of colleges and universities.[15]

Non-profit entities that are awarded their tax-exempt status on the basis of their charitable activities qualify for their exemption under § 501(c)(3) of the Code.[16] Section 170, which authorizes donors to take deductions for their charitable contributions, only authorizes the deduction when contributions are

10. I.R.C. § 501(c)(3) (2019).

11. I.R.C. § 170(c)(2)(D) (2020).

12. Roger Colinvaux et. al, *Evaluating the Charitable Deduction and Proposed Reforms*, URBAN INST. 1, 5 (2012), https://www.urban.org/sites/default/files/publication/25491/412586-Evaluating-the-Charitable-Deduction-and-Proposed-Reforms.PDF ("The charitable contribution deduction is a long-standing feature of the federal income tax. Enacted in 1917, four years after the income tax, it is linked to tax exemption . . . ."); *see also* Fleischer, *supra* note 7, at 511–13.

13. Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. L. REV. 1307, 1309 (2012) ("The deductibility of charitable donations is one of the most well-known aspects of our tax system.").

14. *See, e.g.*, Philip T. Hackney, *What We Talk About When We Talk About Tax Exemption*, 33 VA. TAX REV. 115 (2013).

15. Most colleges and universities are organized as tax-exempt entities under Internal Revenue Code § 501(c)(3). Because they are charitable organizations, they are also eligible to receive charitable contributions that give rise to a deduction for the donor. I.R.C. § 170(c)(2)(D) (2020). However, some colleges and universities are organized as for-profit institutions, accruing profits for the shareholders of the institution. For a discussion of the differences between non-profit and for-profit educational institutions, see David J. Deming et al., *For-Profit Colleges*, 23 FUTURE CHILD. 137 (2013).

16. *See* I.R.C. § 501(c)(3) (2019). The other subparagraphs of § 501(c) identify other categories of entities that qualify for tax exemption. These include, for example, labor organizations (§ 501(c)(5)), chambers of commerce (§ 501(c)(6)), recreation clubs (§ 501(c)(7)), and Armed Forces auxiliary units (§ 501(c)(19)), among others.

made to entities identified in § 501(c)(3)—in other words, charitable entities. The charitable contribution deduction is the focus of much legal scholarship, and is, at least arguably, the more well-known of the tax benefits.[17] This tax benefit is claimed by the donor making the contribution, rather than by the entity itself. As scholars regularly note, the benefit of a charitable contribution deduction is generally regressive, offering a larger tax benefit to higher-income taxpayers making the same contribution as a lower-income taxpayer.[18] The charitable contribution deduction has the further problem of being "hypersalient," often motivating charitable giving even by those who will not ultimately benefit from the deduction.[19] While the charitable contribution tax benefit is nominally a benefit to donors, most commentators agree that, at least to some extent, the incidence of the benefit accrues to the charitable entities themselves, since donors are likely motivated to give more than they would without the deduction, thereby increasing the total amounts received in contributions by charitable entities.[20]

The second tax advantage available to all non-profit entities under the Internal Revenue Code's definition provided in § 501 is the exemption from the income tax for most of the income the entity earns.[21] The justification for

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17. *See* Faulhaber, *supra* note 13, at 1309.

18. Because deductions reduce income in the highest tax bracket first, taxpayers whose income places them in a higher tax bracket will get a larger tax benefit from a deduction than will taxpayers whose income places them in a lower tax bracket. This difference is further exacerbated by the existence of the standard deduction, since most lower income taxpayers will elect to take a standard deduction rather than itemizing their deductions, meaning that their charitable contributions will provide no tax benefit at all. For a further discussion of this problem, see John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203 (2011).

19. *See* Faulhaber, *supra* note 13, at 1309. Taxpayers will only take the charitable contribution deduction under § 170 if they itemize their deductions rather than taking the standard deduction. *See* I.R.C. § 170 (2020). Because the 2017 tax bill also increased the size of the standard deduction, fewer taxpayers itemize their deductions now than ever before. Nonetheless, as Faulhaber points out, many taxpayers are motivated by the availability of the deduction, even though they will not ultimately itemize. *See* Faulhaber, *supra* note 13, at 1309–10.

20. *See* Faulhaber, *supra* note 13, at 1319 ("Although some donors likely give to charitable organizations solely out of altruism, studies suggest that many donors take account of the deduction when deciding to give.").

21. I.R.C. § 501 (2019) ("An organization described in subsection (c) or (d) . . . shall be exempt from taxation under [this subtitle] . . . ."). There is significant debate around both the existence of this exemption as well as how far it should reach. *See* Kimberly Scharf & Sarah Smith, *Charitable Donations and Tax Relief in the UK*, *in* Charitable Giving and Tax Policy: A Historical and Comparative Perspective 120, 121 (Gabrielle Fack & Camille Landais eds., 2012); Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395 (1997) (discussing why the exemption is justified in contemporary tax policy

this tax benefit stems from the rationale that these entities are all 'non-profits,' meaning that, unlike for-profit entities, the entities identified under § 501(c) do not have any shareholders who participate in the profits of the entity.[22] As a result, any operations income the non-profit earns while participating in its general activities will be exempted from income tax, as will any investment income the non-profit earns. The exception to this exemption is for income earned by the charity that meets the statutory definition of "Unrelated Business Taxable Income" or "UBTI."[23] Any UBTI earned by the non-profit will be subject to the income tax. The imposition of tax is generally seen as justified in this case, because it attaches to income that is not related to the non-profit activities of the organization.[24] In other words, the justification for the exemption of this organization's income from tax does not reach to the income identified as UBTI. A further rationale for this special treatment of UBTI is that allowing such income to be exempted from tax would give an unfair competitive advantage to businesses organized as non-profit entities but nonetheless engaging in unrelated business activity. For instance, a university organized as a non-profit entity under the Code, based on its educational activities, should not be permitted to operate a tax-exempt pasta business.[25] If that were permitted, the university's pasta business would be

and how far it should reach). As a matter of historical precedence, the exemption derives from England, because "[w]hen income tax was introduced in 1799, charitable organisations were specifically exempted from paying the tax on the grounds that the activities of charitable organisations generated a 'public benefit'—i.e. relieved pressure from the public purse." Scharf & Smith, *supra*, at 121.

22. Henry B. Hansman, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) ("A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees . . . . It should be noted that a nonprofit organization is not barred from earning a profit.").

23. Andrew M. Dougherty, *Unfair and Unintended: The Tax-Exempt Organization Blocker Loophole*, 2013 B.Y.U. L. REV. 1341, 1343 (2014) ("Under the Revenue Act of 1950, Congress passed rules that placed an income tax on any part of a tax-exempt organization's income that met the following requirements: (1) income was received from a trade or business; (2) the trade or business was 'regularly carried on' by the tax-exempt organization; and (3) the trade or business was not 'substantially related' to the tax-exempt organization's purpose (income that met these requirements is referred to as unrelated business taxable income or UBTI).").

24. *Id.*

25. *See* Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 FORDHAM L. REV. 857 (2007). One of the most famous examples of a non-profit entity operating an unrelated business was New York University School of Law, which, beginning in the 1940s, owned and operated the C.F. Mueller Co., which was, at the time, the largest producer of macaroni in the United States. *Id.* at 862. The government tried to challenge the exemption from tax of Mueller's income, but lost in the courts. *Id.* In response, Congress enacted the rules around UBTI in 1954. *Id.*

receiving a government-subsidized competitive advantage over for-profit pasta businesses, because the non-profit would not have to pay tax on its income, while its for-profit competitors would have to pay tax on their income. Other than the exception for UBTI, any income earned by non-profits engaged in activities related to their non-profit purpose, and, importantly for this essay, all investment income earned by non-profits, are exempted from the federal income tax.[26]

Much of the scholarship around the non-profit tax benefits does not attempt to distinguish between the deduction for contributions and the exemption for income at the theoretical level. The justifications for the two benefits for charitable activities are often considered together, with no meaningful distinction made between the two very different provisions. One notable exception to the collapse of this distinction is Professor Daniel Halperin's work on the tax-exemption for non-profits, which does, in fact, grapple with this question, articulating the arguments around the income tax exemption for non-profits as separate and distinct from the charitable contribution deduction.

As Halperin has pointed out, the exemption from income tax provides some benefits to non-profit entities, but those benefits are relatively limited.[27] After all, if charities were taxable entities, they would then also be eligible to take business deductions to offset their income, to the extent that the income was being used to fund the operations of the entity, just as a for-profit taxable entity can take such deductions under current law.[28] Section 162 allows taxable entities to reduce their taxable income by the expenses they incur in

at 863. For a more detailed discussion of this and other transactions in place before the UBTI rules, see *id.* at 860–63.

26. *See* Dougherty, *supra* note 23, at 1346 (proving an in-depth discussion of how there are limits to the passive income that a non-profit entity can earn under this exemption, in particular if the income is generated from debt-financed investments). One might ask, if Congress imposed tax on UBTI in order to place non-profits on an even playing field with for-profits when they operate businesses unrelated to their non-profit purposes, might that argument not expand to the imposition of tax on investment income as well? Assessing such a tax would then put non-profits on an even playing field with all other investors with respect to this non-charitable activity as well.

27. Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 N.Y.U. TAX L. REV. 283, 284–85 (2011) ("Income tax exemption, in most circumstances, will affect only the relative cost of setting aside funds for the future as compared to providing current benefits. It will not seriously concern those organizations that spend nearly all their funds on current activities.").

28. *Id.* at 285 ("[A charity's] [i]ncome from related activities could be offset by deductible expenditures required to earn such income. . . . [I]f an expenditure would be deductible when made, tax exemption for amounts set aside for such expenditures does not reduce the present value of tax payments even if these expenditures are deferred.").

operating their businesses.[29] Non-profit entities are not entitled to § 162 deductions under the current law because they do not operate a "trade or business."[30] However, because these entities are not currently subject to the income tax, they have not needed the tax benefits provided by this provision. Since none of the income received by non-profits in connection with their central activities is taxable, these entities do not need to reduce their income through the use of deductions. However, were the law to change such that some amount of the income earned by non-profit entities, even income produced by their ongoing charitable efforts, were taxable, it would be appropriate to allow deductions against that income for the expenses necessary to produce it or to otherwise operate their charitable institutions.[31] Such a change would require Congress to use its authority to amend the law around the definition of "trade or business" to include income-producing charitable activities, but that would be appropriate, were this income subject to tax. Alternatively, a new tax provision could be added defining deductible expenses for charitable entities. Were this change to be made, and such deductions extended to include costs incurred by charitable organizations in the course of their non-profit activities, then even if non-profit entities were subject to the income tax, only income that exceeded the amount spent on charitable activities for the year would be subject to the tax.[32] In this way, non-profit entities could be treated just like for-profit entities, and their net income subjected to the income tax, even while leaving in place the deduction

29. I.R.C. § 162 (2017) ("There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .").

30. *See* F. Ladson Boyle, *What Is a Trade or Business?*, 39 TAX LAW. 737, 739 (1986). While there is no statutory definition of the statutory phrase "trade or business," significant amounts of case law have been generated in understanding what that phrase means. *See id.* at 738–39. At a minimum, courts have held that taxpayers must have a profit-seeking motive in order to be engaged in a trade or business. *See id.* at 739. That motive would, of course, be in conflict with the status of non-profit entities. *See* Richard Schmalbeck et al., *"What is a 'Trade or Business'?"*, *in* FEDERAL INCOME TAXATION 499 (Wolters Kluwer ed., 2018).

31. The deductibility of business expenses is justified as a way to more accurately measure income. A tax on gross receipts, rather than on net income, would penalize businesses with higher costs. The deduction of business expenses under § 162 results in a tax only on the actual increase in wealth of the business in the taxable period. For a further discussion of this issue, see Halperin, *supra* note 27, at 297–98, 298 n.59.

32. As an example, consider a charitable entity that operates a fitness studio, like the YMCA. The non-profit would have income in the form of fees collected from members. However, the non-profit would also have expenses from the provision of services and the operation of the fitness studio. Were the income subject to tax, but expenses deductible, only the total income in excess of the expenses would be taxable, just as if this were a for-profit business.

for charitable contributions to these entities.

In a world where non-profit entities were subject to the income tax, but eligible to take deductions for their expenses, because the income earned by the entity in excess of the expenses would not be distributed to shareholders (that being the "not-for-profit" element of such entities), the question would remain, what happens to the income? In other words, what will the charity do with its "profit"? Amounts that exceed the annual spending of a charity in any particular year can either be invested in capital expenditures, designed to further the entity's charitable purposes, or can be invested in a financial asset.[33] If the charity chooses to invest the excess in income-producing financial assets, rather than in capital expenditures that further the entity's charitable purpose, then the excess will produce additional income, which would then also be subject to the income tax, if the exemption were eliminated. If the excess income is invested in capital expenditures, then assuming charitable entities were subject to the income tax regime as it currently stands, the same rules that apply to for-profit entities making capital expenditures would apply. The charity would be denied an immediate deduction, because the cost would not be a deductible expense, and it would only be able to recover the investment over a period determined under the depreciation tables, or, if the investment is made in a non-depreciable asset, the investment would only be recovered when the asset is sold.[34] If there were gain at that point, then that gain would also be subject to the income tax.[35]

The exemption from income taxation for investment income has given non-profits a dramatic advantage when it comes to investing, accumulating income, and expanding investment assets. Because any investment earnings by non-profits are exempted from income tax, non-profit entities can invest and re-invest all on a pre-tax basis, suffering no diminution of their investing capacity as a result of tax.[36] One of the results of this advantage is the

33. Daniel Halperin, *Tax Policy and Endowments—Is Excessive Accumulation Subsidized?*, 67 EXEMPT ORG. TAX REV. 17, 25 (2011).

34. *See* I.R.C. §§ 167 (2007), 168 (2020), 179 (2018). This approach is currently in place for taxable entities, under the various provisions allowing accelerated and bonus depreciation and immediate expensing. For a careful and complete discussion of the role of the government in subsidizing capital expenditures in the for-profit business context, see Rebecca Morrow, *Government as Investor: The Case of Immediate Expensing*, 106 KY. L.J. 1 (2017).

35. I.R.C. § 1001 (2020). Of course, if the gain on the sale were then spent on an expense that qualified for deduction under § 162, then the tax liability would be reduced accordingly. *Id.*

36. Consider an example: assume an individual subject to tax at 20% invests $100 and generates a 10% annual return. If we assume that the individual pays tax annually on the return (as would be true if that return were distributed as a dividend) and invests the post-tax amount back into the income-

increasing world of university endowments and their investment advisors. Public and private universities in the United States collectively hold over $566 billion.[37] However, the wealth is not distributed evenly among institutes of higher education—over 75% of endowment assets are held by only 12% of universities.[38] This extreme wealth generates big business. Most university endowments have full-time university employees whose responsibility is overseeing the endowment.[39] But these universities also hire private equity managers, who manage the fund in exchange for a fixed percentage fee as well as a percentage of the annual return.[40] In other words, many universities have focused significant efforts on treating money received as charitable contributions in just the way that hedge funds and private equity funds treat their assets. And universities have had some success with this model, dramatically increasing the size of their endowments in recent decades. However, many of the objections to the accumulation of wealth in the hands of private individuals also apply to concerns about massive endowments held by private, exclusive universities. Further, the growth of these endowments through the accumulation of contributed funds raises questions about the charitable nature of the institution and the intentions of the donors. The next part of this essay outlines some of these concerns.

generating investment, years 1 and 2 would look like this: at the end of year 1, our taxpayer will have $10 of income and pay $2 of tax. She then reinvests the post-tax return of $8, meaning that she starts year 2 with an investment of $108, which generates $10.80 at the end of year 2. She pays $2.16 of tax on the year 2 return. As a result, her original investment of $100 has a value of $116.64 at the beginning of year 3. By contrast, a non-profit entity that makes the same $100 investment at the beginning of year 1 will have $121 at the beginning of year 3, because neither the year 1 nor year 2 returns will be subject to tax. This $4.36 difference is entirely due to the non-profit entity's tax exemption.

37. MOLLY F. SHERLOCK ET AL., CONG. RESEARCH SERV., R44293, COLLEGE AND UNIVERSITY ENDOWMENTS: OVERVIEW AND TAX POLICY OPTIONS (2018).

38. *Id.*

39. *See, e.g.*, *Financial Administration*, *Harvard's Endowment*, HARV. U., https://finance.harvard.edu/endowment%20 (last visited Mar. 6, 2021) ("Harvard Management Company (HMC)—a nonprofit, wholly owned subsidiary of Harvard University—has managed the University's endowment portfolio since 1974.").

40. Chris Flood, *Leading US University Endowments Struggle to Beat Tracker Funds*, FIN. TIMES, (Dec. 8, 2019), https://www.ft.com/content/beeae17a-f6a4-42cf-967a-17a858a40ca6 ("Many US universities have followed the example of Yale, whose chief investment officer David Swensen and senior director Dean Takahashi helped pioneer the 'endowment model' where private equity managers and hedge funds play a larger role in an investment portfolio.").

III. OBJECTIONS TO AN UNLIMITED INCOME TAX EXEMPTION FOR NON-PROFITS

The decision not to tax the net income of non-profit entities is a policy choice by Congress and should be evaluated independently from the policy choice to offer a tax deduction for contributions made to charitable entities. We should then ask, what is the behavior that is incentivized by the income tax exemption, and is that behavior consistent with the public policy goals motivating the tax exemption (and charitable deduction) in the first place? We might want to motivate charitable contributions under the belief that the actions taken by charities are worth supporting, and even decide that we want to exempt the charity's income from tax to the extent that it is being used to advance charitable purposes. We might nonetheless decide that the public policy goals of incentivizing the use of charitable contribution funds and income earned through the provision of charitable services to engage in further charitable activities are not served by providing an unlimited exemption to non-profits who invest their excess income, thereby generating more income, which they may well accumulate indefinitely.

The contemporary literature on the accumulation of wealth and income by individuals has demonstrated, in that context, several of the concerns associated with the accumulation of wealth in the hands of the few.[41] These concerns include worries about the incompatibility of a robust democracy with the concentration of wealth. In the contemporary United States, wealth often means access to power and to a space at the table with those who have the authority to make or amend the law. In such a society, one goal of the tax system is to try to prevent the creation of such a dichotomy between those with power and those without. While much of the scholarly writing about this problem focuses on the individual, the same concerns should apply to the accumulation of wealth by anybody, including by a non-profit entity. The accumulation of wealth results in an accumulation of power for that body,

41. *See generally* Miranda Perry Fleischer, *Divide and Conquer: Using an Accessions Tax to Combat Dynastic Wealth Transfers*, 57 B.C. L. REV. 913 (2016) (discussing the concerns of concentrated wealth and dynastic wealth transfers in the individual taxpayer context). "[W]ealth enables one to directly influence the political process in a variety of ways: by influencing the media's news and editorial coverage through the granting or withholding of advertising; by making substantial (yet limited) contributions directly to candidates, parties, and political committees and unlimited contributions to § 501(c)(4) organizations that engage in issue advocacy and campaign intervention; and by making contributions to and receiving increased access to elected officials already in office." *Id.* at 919 (footnotes omitted).

which has the potential to result in an outsized influence on rulemaking in what should be a democracy. Whether that power is concentrated in the hands of an individual or a charity, we should be concerned about it.

In addition to concerns about the significant accumulation of wealth in the hands of a single institution, and the anti-democratic threat that might represent, there is another reason to be uniquely concerned about universities accepting charitable contributions that they then invest indefinitely through the endowment. Thinking again about the charitable purposes of universities that entitle them to tax exemption in the first place, universities are engaged in educational and research missions.[42] Their receipt of contributions that generate a deduction for the donor is predicated on that charitable mission. While universities that receive donations in excess of their operating expenses or not targeted to a specific cause are wise to invest those funds, the charitable enterprise must always drive the universities' decisions. However, the evidence suggests that universities lose sight of their charitable mission when it comes to the endowment. Indeed, while university endowments saw an average rate of return of 12.2% in 2017, the average payout rate was only 4.4%.[43] In other words, the vast majority of the return on the endowment went to pay for the maintenance of the endowment, or was reinvested in order to generate future returns. These numbers raise the question of whether amounts received by universities with large endowments are actually contributing to the charitable mission of the university. Some commenters note that, for universities with significant endowments, funds in those endowments will eventually benefit the charitable mission. However, is there clear evidence for this? At some point, are the amounts so large that the university simply cannot consume the assets in the endowment for the continuity or expansion of its charitable mission?

Further complicating the questions of universities' motivations regarding their endowments is the behavior of universities during the COVID-19 pandemic. Universities across the country saw dramatic decreases in enrollment leading to decreased tuition dollars and lower revenues from housing and dining contracts, public institutions saw cuts to their state and federal funding, and the costs of offering courses either online or in a socially distanced classroom added unexpected budget items.[44] However, most

42. *See* I.R.C. § 501(c)(3) (2019).
43. SHERLOCK ET AL., *supra* note 37.
44. *See generally* ANDREW P. KELLY & ROONEY COLUMBUS, COLLEGE IN THE TIME OF CORONAVIRUS: CHALLENGES FACING AMERICAN HIGHER EDUCATION, AM. ENTER. INST. (2020).

universities dealt with the crises not by turning to the endowment, but by cutting costs. College and department budgets were slashed, resulting in salary reductions, staff and faculty furloughs, and even layoffs.[45] But given that the university endowment is meant to operate, at least in part, as a "rainy day fund," shouldn't we have seen universities dipping into their endowments in order to cover costs during this unprecedented time? Rather than firing employees or letting students whose families could no longer afford tuition drop out, universities with robust endowments should have spent out from the endowment in order to address the crisis. While there are clearly some concerns about spending out an investment when the market is down, the market was not, in fact, consistently down during the months that the coronavirus pandemic raged on. Universities concerned with ensuring their continued ability to engage in their charitable purposes should have strategically accessed their endowments in order to permit them to do so. The fact that so few of them did this should raise suspicion about the relationship most universities have with their endowments. Rather than thinking of the endowment as one more tool available to help the university achieve its charitable goals, most universities see the endowment as, in meaningful ways, separate from the university's mission. Instead, the university endowment is invested for its own sake—growth is the goal above and beyond any charitable principle.

IV. THE ACCUMULATION OF WEALTH, THE INCOME TAX EXEMPTION, AND HIGHER ED

A brief perusal of the news from the past few years leads to the conclusion that there may not be wide public support for large, income-accumulating charitable entities.[46] In particular, the types of charities with the largest income-producing endowments, primarily wealthy private universities, have come under fire for not spending more of their assets to provide services and

45. *Id.*

46. In particular, charities named for or operated by political figures have received significant criticism, including, in some instances, legal actions. *See, e.g.*, *FBI Investigating Clinton Foundation Corruption Claims*, L.A. TIMES (Jan. 5, 2018, 2:15 PM), https://www.latimes.com/nation/nationnow/la-na-fbi-clinton-foundation-investigation-20180105-story.html (explaining that critics have accused the foundation of corruption). *See also* Merrit Kennedy, *Judge Says Trump Must Pay $2 Million over Misuse of Foundation Funds*, NPR (Nov. 7, 2019, 7:36 PM), https://www.npr.org/2019/11/07/777287610/judge-says-trump-must-pay-2-million-over-misuse-of-foundation-funds.

reduce costs for their current students.[47] The accumulation of income and investment prioritizes the needs of future constituents over current ones. Making the decision to save earned income or to reinvest it means that the benefits of that income will accrue to the charitable beneficiaries of the future, rather than those of today. In the case of universities, spending to benefit current students reduces the amount of income available for reinvestment and the production of future income. Choosing to save or reinvest that income instead means more funds will be available to be used by the university for the benefit of future students.[48]

Creating a tax system that incentivizes current spending over accumulation need not result in higher education institutions with no savings at all. The tumultuous economy of the past ten years makes clear that we should not create rules to penalize charities that maintain some kind of savings, since universities that had the financial cushion to withstand the rough seas of the Great Recession were in much better shape than those who had smaller reserves.[49] But we might ask what goals are achieved by saving and investing, and what, after all, the charitable purpose of the university is. Indeed, recent years have seen a variety of stories that make clear that even those universities with extremely robust endowments have current students who struggle financially.[50] In his book, *The Privileged Poor: How Elite*

47. Kellie Woodhouse, *Widening Wealth Gap*, INSIDE HIGHER ED (May 21, 2015), https://www.insidehighered.com/news/2015/05/21/rich-universities-get-richer-are-poor-students-being-left-behind ("[The] 40 richest universities have increased their assets by half since the recession, more than double the increases experienced by the least-wealthy universities rated by Moody's. And while many of the wealthiest colleges offer need-based scholarships for their poorest students, they enroll a relatively small percentage of low-income students compared to their less wealthy peers.").

48. This prioritizing of future generations over current generations is a concern that appears in other areas of the tax law as well. In particular, the work of Neil Buchanan in consideration of the Social Security system in the United States introduces much of the same analysis. For Buchanan's foundational work in this area, see Neil H. Buchanan, *What Do We Owe Future Generations?*, 77 GEO. WASH. L. REV. 1237, 1238 (2009). Buchanan observes, "[W]e currently fall well short of our responsibilities in many areas but—surprisingly—[] we might well be overemphasizing the interests of future generations in others." *Id.* at 1237.

49. *See* Woodhouse, *supra* note 47 (stating that less wealthy universities have been slower to rebound from the recession than larger universities with endowments); Halperin, *supra* note 27, at 283 ("[T]he precipitous decline in the market, which has resulted in expenditure cutbacks at many institutions, may have suggested that prior distributions were, in fact, not conservative enough.").

50. *See generally* Clint Smith, *Elite Colleges Constantly Tell Low-Income Students that They Do Not Belong*, ATLANTIC (Mar. 18, 2019), https://www.theatlantic.com/education/archive/2019/03/privileged-poor-navigating-elite-university-life/585100/ ("While many top schools have taken steps to provide more access to disadvantaged students and become more socioeconomically diverse, they remain saturated with wealth. Most low-

Colleges are Failing Disadvantaged Students, Anthony Abraham Jack exposes many of these problems.[51] Universities with some of the largest endowments in the country also hire their own students to clean bathrooms in the dorms, thereby further reifying the distinction between the independently wealthy students and those who can only attend the university with the kind of robust financial support that has become more common in recent years. While many of these universities have taken the meaningful step of offering full-tuition and, in some instances, full room and board scholarships to low- and middle-income students, there is still room to improve the quality of these students' lives while they are enrolled.[52]

Recent scandals associated with admissions to elite colleges have further soured the public on higher education, as news emerges that, for decades, wealthy parents have engaged in deceit and bribery to get their unqualified children admitted to exclusive undergraduate schools.[53] Public discourse around the so-called "Varsity Blues" scandal prompted renewed discussions about other distasteful higher education admissions practices that don't make the front pages and don't prompt federal indictments—large charitable gifts to universities are often correlated with admissions letters for the children or grandchildren of the donors, and legacy admissions amount to a significant percentage of enrollments at Ivy League schools every year.[54] And these practices don't only occur at the schools at the very top of the higher education food chain—recent headlines point to schools like Notre Dame, Baylor, and the University of Southern California as places with significant numbers of legacy students.[55] And the data continue to show that wealthy schools are

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income students still receive their education elsewhere, disproportionately attending for-profit colleges, community colleges, and less-selective four-year institutions.").

51. ANTHONY ABRAHAM JACK, THE PRIVILEGED POOR: HOW ELITE COLLEGES ARE FAILING DISADVANTAGED STUDENTS (2019).

52. *See, e.g.*, Anemona Hartocollis, *U.S.C. Offers Free Tuition to Students Whose Families Make $80,000 or Less*, N.Y. TIMES (Feb. 20, 2020), https://www.nytimes.com/2020/02/20/us/usc-free-tuition.html; Vanessa Romo, *University of Texas-Austin Promises Free Tuition for Low-Income Students in 2020*, NPR (July 10, 2019, 5:01 PM), https://www.npr.org/2019/07/10/740387601/university-of-texas-austin-promises-free-tuition-for-low-income-students-in-2020.

53. *See College Admissions Scandal: Complete Coverage of a Brazen Cheating Scheme*, N.Y. TIMES, https://www.nytimes.com/news-event/college-admissions-scandal (last visited Mar. 6, 2021) (providing a timeline of events related to the 2019 college admissions scandal).

54. Caitlin Flanagan, *They Had It Coming*, ATLANTIC (Apr. 4, 2019), https://www.theatlantic.com/ideas/archive/2019/04/what-college-admissions-scandal-reveals/586468/. *See also* Stephen Clowney, *Doing Affirmative Action*, 111 MICH. L. REV. FIRST IMPRESSIONS 27 (2013).

55. Brandon Kochkodin, *Notre Dame and Baylor Admit More Legacies Than Harvard and Yale*,

more likely to perpetuate and even exacerbate wealth and income disparities. Recent research by Raj Chetty and others shows, among other things, that applicants whose parents are in the top 1% of income earners are seventy-seven times more likely to attend an Ivy League school than those with parents in the bottom income quintile.[56] But an important additional finding of the work of Chetty and his collaborators is that attending certain schools is correlated with upward economic mobility, indicating that university attendance, at least in some instances, can start to combat some of the larger economic problems in the United States.[57] While attendance at these schools may well provide economic advantages to the small numbers of low-income students who attend each year, it also seems clear that the vast majority of the benefits of attending these schools are concentrated in the hands of those who already find themselves at the top of the income and wealth scales. If other parts of the tax code are aimed at combatting income and wealth inequality, it seems at least worth raising the question of whether the income tax exemption that provides economic benefits to schools with these kinds of profiles might be inconsistent with larger public policy goals.

Is the mere provision of education sufficient to qualify the institution as charitable, and therefore eligible for exemption from income tax, or should such institutions have some obligation to ensure that enrolled students do not suffer financially as a result of their enrollment? Should the charitable activities of universities include ensuring that the more financially insecure students receive support from the institution? Is the provision of education in and of itself charitable, even if the education is being provided to individuals with no evident need? Our current tax law defines "charity" broadly, and does not ask about the need of those to whom the charitable services are being provided.[58] Several scholars, including, most notably, Miranda Perry Fleischer, have commented that it may be time to break the definition of charity down further, so that art museums and providers of education would need to demonstrate their charitable purposes beyond just the provision of art

Bloomberg (Mar. 21, 2019, 3:00 AM), https://www.bloomberg.com/news/articles/2019-03-21/notre-dame-baylor-top-harvard-yale-for-most-legacies-admitted.

56. Raj Chetty et al., *Mobility Report Cards: The Role of Colleges in Intergenerational Mobility* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 23618, 2017), https://www.nber.org/system/files/working_papers/w23618/w23618.pdf.

57. *See id.* at 2 (describing an increase in earning power for college graduates regardless of original socioeconomic status).

58. *See "Charitable" Purposes,* IRS, https://www.irs.gov/charities-non-profits/charitable-purposes (last updated Feb. 2, 2021).

or education.[59] Indeed, some might argue that, because the vast majority of the beneficiaries of schools like Harvard and Yale are among the most financially secure members of society, the activities of these non-profits should not be subsidized by the federal government.[60] Rather, such entities should first be required to demonstrate that their charitable activities benefit at least some portion of the population that requires economic assistance.[61] If this is a policy goal of the federal tax system, then the system should be designed to encourage spending in support of financially needy students who are currently enrolled, rather than remaining agnostic between such spending and the accumulation and reinvestment of a university's income. One way to do that would be to create a tax system that taxed income that was not used for current charitable activities.

Of course it is also true that universities provide benefits to society beyond just the education of their students. The characterization of universities as charitable entities is as much attributable to the faculty's research and service work as it is to the university's educational mission. Scholars associated with universities engage in research and service that has wide-ranging and far-reaching consequences. Universities who choose to use their endowments to support their research and service missions, rather than (or in addition to) supporting the needs of their lower-income students, are nonetheless engaging in activity consistent with their charitable purposes. However, again, evidence from recent years suggests that, rather than using endowment funds to support research and service by university employees, universities have regularly allowed those areas to suffer financially, even while, in some circumstances, the endowment continues to grow.[62]

The question remains: what are the incentive effects currently created by the income tax exemption, and is there a way to adjust these incentives to make them align more neatly with the public policy goals we seem to have?

59. MIRANDA PERRY FLEISCHER, SER. NO. 16-210, HOW IS THE OPERA LIKE A SOUP KITCHEN? 20 (2016).

60. *See* Woodhouse, *supra* note 47 (noting that some tax experts question the aid that is given to these universities). All entities that qualify as charities are subsidized in two ways—their income is exempt from tax under § 501, and the donations made to them are deductible to the contributor under § 170. This means that the government collects less tax than it would without these two provisions in place.

61. Determining what such a policy would look like is beyond the scope of this essay but has been carefully considered by scholars in other contexts. *See, e.g.* Fleischer, *supra* note 41.

62. *See, e.g.*, Francois Furstenberg, *University Leaders Are Failing*, THE CHRONICLE OF HIGHER EDUCATION (May 19, 2020).

One possibility would be to continue to provide exemptions for investments that are made in expenditures that continue the charitable efforts of the non-profit.[63] In other words, even if the income is not used for activities that would traditionally provide a deduction, one could provide something like "immediate expensing" for investments in charitable purpose expenditures. While such an approach is not generally consistent with the theoretical distinction between current deductions for expenses and depreciation schedules that track actual declines in value, it is, in fact, consistent with many of the current income tax provisions aimed at incentivizing investments in large capital expenditures.[64] For the same reasons that Congress believes immediate expensing works to incentivize investments by for-profit entities, we would expect to see increased investment in capital expenditure projects by non-profits that would otherwise face taxation on their income. The net result of this would likely increase both current spending on charitable activities and investment in charitable expenditures, thereby reducing the amount of income available for accumulation and investment in income-producing assets unrelated to the charitable purpose of the entity (which would be the only remaining income subject to the tax). Because a tax like this would likely change the incentives of the non-profits it affects, it is unlikely to be a significantly revenue-generating tax. However, creating more current spending may more accurately reflect the goals we have in the first place, so lack of revenue generation should not be an objection. If the imposition of this tax creates taxpayer behavior that more neatly aligns with our policy goals regarding the activity of non-profit entities, then the provision should be pursued.

Finally, as I turn to an examination of the new university endowment excise tax, it is worth asking again, why might we generally be unhappy with significant accumulation of wealth by private universities in particular? As I mentioned above, many scholars have written about the concerns regarding the accumulation of wealth by individuals in contemporary society, and the

63. Halperin, *supra* note 33, at 18.

64. There are many examples of statutes Congress enacts in order to use the tax code to incentivize particular spending. One of the best examples of this strategy is the immediate expensing provision found in § 179. Under this rule, the taxpayer takes an immediate deduction for the amount spent on an asset, even though the capitalization rules would otherwise require that the amount spent be added to basis and only recovered over time through the typical depreciation rules. For an explanation of the § 179 provision and the way it creates a government investment in the asset, see Morrow, *supra* note 34.

way that such accumulation has the potential to threaten democracy.[65] So, one further objection, as described above, is that the accumulation of wealth and income in the hands of non-profit entities poses similar risks.[66] However, there are further reasons to worry about the risks posed by private universities in particular. In addition to concerns expressed above that the attendees of these schools are benefitting in ways that reify and even exacerbate income inequality, we might oppose the accumulation of wealth in the hands of those institutions for the same reasons some have for opposing large accumulations of wealth in the hands of families—because we see that wealth as creating undue political influence in the hands of the holders of that wealth.[67] Our objections to concentrations of wealth in the hands of individuals could well apply to concentrations of wealth in the hands of universities.[68] One piece of evidence to justify this concern comes from the concerted response organized by the wealthiest universities to the new excise tax, as discussed in the next Part of this essay.

V. UNIVERSITY ENDOWMENT EXCISE TAX

The mantra of the Republican tax proposals in 2017 was to cut, cut, cut. So how did the first ever tax on the endowment income of universities end up as part of the final bill? One easy political explanation is the general conservative disdain for colleges and universities, long seen as liberal strongholds, and in some circles, generally viewed as responsible for indoctrinating the young and making them all into Democrats.[69] Under such a view, it is not surprising that the tantalizing prospect of imposing a tax on the piles of cash in those universities' coffers was irresistible. It remains true that taxes are generally seen as antithetical to the Republican political project, largely thanks to the efforts of Grover Norquist and his group, Americans for

65. *See, e.g.*, Fleischer, *supra* note 41.
66. *See supra* Part III.
67. For a discussion of universities' mobilization and political responses to the prospect of a new tax, *see infra* notes 89–91 and accompanying text. *See also, e.g.*, James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 825 (2001).
68. For a list of the largest endowments held by universities in the United States, see National Center for Education Statistics, *Endowments*, U.S. DEP'T OF EDUC. (2019), https://nces.ed.gov/fastfacts/display.asp?id=73.
69. The generally held conservative view that attending college turns students more liberal became the focus of a recent scientific study, which seemed to contradict this view. *See* Scott Jaschik, *Liberal Indoctrination? Not So Much*, INSIDE HIGHER ED (February 5, 2018).

Tax Reform, who have convinced the vast majority of Republicans elected to national office to sign a pledge never to support tax increases on individuals or corporations.[70] Perhaps because they are non-profit corporations, raising taxes on universities was seen as compatible with the pledge? However it was that the Republicans who supported this tax came to view it as consistent with their larger views about tax, this new excise tax became part of the bill. The pragmatic reason for its inclusion likely has less to do with any political philosophical commitments related to the rightness or wrongness of tax, and more to do with a Senate rule governing which bills can be passed with a simple majority and which require sixty votes.[71] The so-called "Byrd Rule" requires that legislation adopted by a simple majority not increase the country's deficit beyond the budget window.[72] This rule led to the inclusion of sunsetting provisions in both the 2001 and 2017 tax bills.[73] As has been widely noted, nearly all of the tax cuts enacted as part of the TCJA are scheduled to sunset by 2025.[74] But the inclusion of the excise tax on university endowment income had the effect of increasing revenue collected through the passage of the legislation, thereby permitting a further reduction of tax rates on individuals and corporations under the bill.[75] In other words, because the budget score of the new excise tax was a net positive, the inclusion of this provision mildly mitigated the negative revenue consequences of the

70. Molly Ball, *Grover Norquist, the Happiest Man in Washington*, ATLANTIC (Apr. 18, 2017), https://www.theatlantic.com/politics/archive/2017/04/grover-norquist-the-happiest-man-in-washington/
523206/.

71. BILL HENIFF, JR., CONG. RESEARCH SERV., RL30862, THE BUDGET RECONCILIATION PROCESS: THE SENATE'S "BYRD RULE" 1–4 (2020) ("A motion to waive the Byrd rule, or to sustain an appeal of the ruling of the chair on a point of order raised under the Byrd rule, requires the affirmative vote of three-fifths of the membership (60 Senators if no seats are vacant).").

72. *What is the Byrd Rule?*, PETER G. PETERSON FOUND., https://www.pgpf.org/budget-basics/understanding-complex-budget-terms-and-processes-and-why-they-matter/what-is-the-byrd-rule (last visited Mar. 8, 2021).

73. *See* HENIFF, *supra* note 71, at 13 ("The potential application of the Byrd rule to the measures was averted by the inclusion of 'sunset' provisions that limited the duration of the tax cuts, thereby preventing any projected deficit increases beyond the applicable budget window."). For a historical perspective and explanation of the role of sunset provisions in the tax legislation, see Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. REV. 656 (2007).

74. Bird-Pollan, *supra* note 1, at 509.

75. For a discussion of the scoring of Congressional budget proposals and the way various proposals affect the bottom line budget score of the bill, see *A Short Primer on the Congressional Budget Office*, COMMITTEE FOR RESPONSIBLE FED. BUDGET (Feb. 14, 2018), http://www.crfb.org/blogs/short-primer-congressional-budget-office.

TCJA. Collecting even a small amount of tax revenue from wealthy universities allowed Republicans to give a boost to the TCJA's bottom line.

Whatever the ultimate rationale for the Republicans' inclusion of the provision, the tax itself is relatively straightforward.[76] The new federal excise tax, enacted as § 4968, imposes a tax of 1.4% on endowment income earned by certain educational institutions.[77] The tax is limited to private universities, whose student bodies are majority U.S. citizens, where over 500 are tuition-paying, and where total assets exceed $500,000 per student.[78]

The requirement of a minimum number of "tuition-paying students" is designed to exclude institutions like Berea College, a small liberal arts college located in central Kentucky.[79] Berea College has been tuition-free since its inception.[80] Instead of paying tuition, students work on campus during their time in college.[81] The model is meant to subsidize the education of low-income students, but requires significant resources in order to allow the college to carry out its mission.[82] When it became clear that Berea (coincidentally located in Senate Majority Leader Mitch McConnell's home state, and very popular here) would be adversely affected by the tax, the tuition-paying students provision was added.[83]

The measurement of assets in excess of $500,000 per student (before the tax is assessed) excludes those university assets that are used to carry out the university's exempt purpose.[84] In other words, the tax is designed to affect

76. *See* I.R.C. § 4968 (2018) (stating the provisions of the "[e]xcise tax based on investment income of private colleges and universities").

77. I.R.C § 4968 (2018).

78. *Id.*

79. For a discussion of how Berea College became the centerpiece of a discussion about the proposed excise tax, see Erica L. Green, *How a Tuition-Free College Turned into a Casualty of the Tax Wars*, N.Y. TIMES (Dec. 20, 2017), https://www.nytimes.com/2017/12/20/us/politics/berea-college-bernie-sanders-mcconnell-tax-cut.html. For a discussion of the exemption ultimately adopted for Berea and similar institutions, see Linda Blackford, *Small Kentucky College Spared Crippling Tax Bill Under Federal Budget Outline*, LEXINGTON HERALD-LEADER (Feb. 8, 2018, 8:08 PM), https://www.kentucky.
com/news/local/education/article199155914.html.

80. *See* Adam Harris, *The Little College Where Tuition Is Free and Every Student Is Given a Job*, ATLANTIC (Oct. 11, 2018), https://www.theatlantic.com/education/archive/2018/10/how-berea-college-makes-tuition-free-with-its-endowments/572644/.

81. *See* Green, *supra* note 79 (explaining the concept of "work colleges").

82. *See id.* (explaining how Berea College uses its endowment to provide tuition for underprivileged students).

83. *See* Blackford, *supra* note 79 (noting the change to the bill would allow Berea to maintain its mission).

84. I.R.C. § 4968 (2018).

primarily investment assets, rather than real property, intellectual property, or any other asset that is used in a way that contributes to the university's charitable mission.[85] This limitation is critical for institutions like Harvard, Stanford, and NYU, whose extensive real property holdings in some of the most expensive areas of the country dramatically increase the total value of their assets. Perhaps more importantly, universities with smaller endowments than those schools, but with expensive real property assets, may well be saved from being subjected to the tax by the existence of this provision.

Even with these significant limitations in place, the new excise tax reflects the first time Congress has attempted to address the question of large endowments and whether such endowments should be subject to tax. Rather than eliminating the income tax exemption from these universities, or imposing tax on university investment income at the same rate as that imposed on taxable entities earning investment income, Congress chose an alternate model, which reaches only a few dozen universities, exempts significant amounts of income, and imposes a relatively low tax. Perhaps we can view this as a step in the direction of recognizing the importance of taxing concentrations of wealth wherever they are found—a toe dipped in the water of taxing the ivory tower. No clear justification was offered by the Republican bill sponsors for designing the tax in this way. Perhaps this seemed to offer less of a precedent for taxing non-profits more broadly, and therefore was more palatable to both the higher education industry and also to anti-tax advocates. Unfortunately, the new tax adds to the complexity of the Internal Revenue Code, arguably unnecessarily, since Congress could merely have eliminated the income tax exemption for these institutions, thereby subjecting them to an existing tax regime.

Unsurprisingly, the imposition of this new tax has generated significant opposition from universities.[86] In its current form, the tax is only expected to affect around forty schools annually.[87] Of course, these schools are among the richest and most powerful institutions of higher learning in the United States, and, as one might have predicted, these universities have mobilized

85. *See* I.R.C. § 4968(d)(1) (providing the definition of assets and net investment income).

86. *See* Catharine Bond Hill, *When Actions Speak Louder Than Lobbying*, INSIDE HIGHER ED (Dec. 10, 2019), https://www.insidehighered.com/views/2019/12/10/instead-lobbying-against-endowment-tax-colleges-should-focus-greater-service-public.

87. *See* Michael Katz, *Stanford University Owes $43 Million Endowment Tax Bill*, CHIEF INV. OFFICER (Feb. 19, 2020), https://www.ai-cio.com/news/stanford-university-owes-43-million-endowment-tax-bill/.

their forces to raise objections to the existence of the tax.[88] This again raises the question of whether universities with significant endowments have acquired disproportionate political power along with their wealth. Certainly, large wealthy universities have outsized influence in their home states, and we have seen the effect of lobbying on the part of wealthy universities with regard to this newly enacted tax.[89]

Now, one might say that the imposition of such a tax at all is evidence that universities, even those with large endowments, do not have political influence as a result of their concentrated wealth. It is true that this is the first time such a tax has been imposed on a tax-exempt entity. The news around the creation of the new excise tax at the time it was imposed focused on the accumulation of wealth and seemed targeted at schools like Harvard and Yale, which were some of the few institutions that would be subject to such a tax. However, the evidence of the outsized influence of such institutions arose after the passage of the law. The universities that would be affected by the new excise tax managed to persuade the IRS to issue a notice of proposed rulemaking "interpreting" the new statute to only apply to income earned after a mark-to-market valuation as of December 31, 2017. In other words, the IRS made the tax entirely forward looking, applying only to increases in value that happened after the law changed.[90] One response to this change would be that this is fair, since the income "earned" before that date should not be subject to the tax—a tax that did not exist at the time the previous income was earned. Imposing the income tax on income earned but not realized before the change in the law would, in effect, make this a retroactive tax—something long looked on with skepticism by scholars and policy makers.[91] The argument here is that the realization requirement is just an accounting mechanism, and that the income in question was really "earned" before Congress decided to impose the excise tax.[92] This might, at first blush, seem like a persuasive

88. *See id.* ("'Over time, the tax will reduce funds available from the endowment to support financial aid and other essential support for our core academic mission,' Stanford University spokesperson Dee Mostofi wrote in a statement to *The Stanford Daily*. 'Stanford strongly opposes the tax and is actively working on efforts to repeal or limit the tax.'").

89. Quinn, *supra* note 6, at 452–53.

90. Guidance on the Determination of the Section 4968 Excise Tax Applicable to Certain Private Colleges and Universities, 84 Fed. Reg. 31795 (Jul. 3, 2019) (to be codified at 26 C.F.R. pt. 53).

91. *See* Michael J. Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1822 (1985) (providing a robust discussion of the role of retroactivity in tax law changes).

92. *See* Gene Steuerle, *Some Notes on 'Retroactive' Income Tax Increases*, TAXANALYSTS (Sept. 6, 1993), http://www.taxhistory.org/www/econpers.nsf/Web/128D83352B83E89E852566DB0063DAB0?

argument. However, the imposition of this new excise tax is not the first time that income which is earned but not yet realized is subjected to a new set of tax laws.[93] Indeed, every time income tax rates change, income that is earned but not realized before the enactment of the new rates is nonetheless subjected to tax under the new rates.[94] Realization is usually a taxpayer-friendly rule, but this might be a way taxpayers lose out because of realization. When the tax rate changes affect taxpayers with earned but unrealized income, exceptions are not granted. But, in this case, it seems evident that lobbyists paid by schools expecting to be subject to the net investment excise tax lobbied for this change and got it. Perhaps they were able to be more effective as lobbyists, since the group affected by the change was relatively small and fairly defined.[95] That might have made their lobbying efforts more effective, as compared to any efforts made against the potential retroactive taxes imposed by changes in tax rates. In any case, this is a wealthy, powerful group that saw an impending impact on its own bottom lines and was able to organize to change the outcome. We do not yet have information about how much tax will be collected under this provision, or empirical evidence about the way the existence of the tax did or didn't change the behavior of schools that expected to be affected by it. In a way, the targeting of the tax on the wealthiest schools (over $500,000 per student *not* being used to further the educational mission, which means campus buildings, equipment, presumably also art and other assets that can plausibly be connected to the educational mission won't count), is a compromise that lets most schools continue to save for a rainy day, while nonetheless encouraging them to spend down some of the income they would otherwise put into the endowment.

One might say this excise tax, because it is only focused on the income produced by investments, and not on the income earned or received by the charity that is then invested in the endowment, doesn't go far enough. If we believe the rationale for imposing the excise tax stems from a distaste for excessive accumulation on the part of these wealthy universities, perhaps we should take that rationale even further. Why are we focused only on

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93. *See id.* (providing examples of when a bill was enacted mid-year or when assets were difficult to calculate).

94. *Id.*

95. *See* Susannah Camic Tahk, *Public Choice Theory and Earmarked Taxes*, 68 TAX L. REV. 755, 762 (2014) (explaining why this might have been the perfect storm for making these lobbyists' efforts effective).

universities? Could the same rationale be used to impose a tax on hospitals? Museums? Other wealthy non-profits? And why stop at the imposition of only a 1.4% excise tax on income produced by the endowment? Why not tax all income produced by the non-profit that is not reinvested in the charitable purposes of the non-profit? Seeing the 2017 tax bill's university endowment excise tax as opening the door to imposing tax as an incentive tool to stop the excessive accumulation of wealth by non-profit entities lets us imagine what else we might see, in particular when driven by a legislature willing to tax the rich.

VI. PATHS FORWARD FOR ENDOWMENT TAXATION

It remains to be seen whether the excise tax on endowment income for wealthy universities will withstand the significant efforts of those universities to combat it. Whether it does or not, it is time to seriously consider whether it is good policy to permit the unlimited accumulation of wealth by private universities. This concern seems especially timely because universities have long defended their endowments as rainy-day funds, arguing that maintaining low payout rates allowed them to maintain the principal for the future, offering a cushion against unexpected hardship. The stress universities have seen as a result of the coronavirus pandemic is unlike anything they've seen before.[96] However, no university has announced it is paying out higher rates from the endowment, or paying down capital, in response to the crisis.[97] This resistance raises at least some questions about the argument that the endowment serves as a sort of insurance.[98] Instead, accumulation for accumulation's sake seems to be the motivation of most universities, and it may well be time to find alternative ways to incentivize universities to think differently about their endowments.

One model that would incentivize universities to spend their investment income in furtherance of their charitable mission would be the imposition of

96. *See* KELLY & COLUMBUS, *supra* note 44, at 2 ("It is hard to overstate how fundamental a change this was for traditional institutions . . . .").

97. *See* Tyler Cowen*, Universities Shouldn't Spend Their Endowments on Coronavirus Relief*, BLOOMBERG (Mar. 25, 2020), https://www.bloomberg.com/opinion/articles/2020-03-25/universities-shouldn-t-spend-endowments-on-coronavirus-relief (listing examples of several universities with large endowments that had announced no plans to dip into their funds to provide housing for students or salaries to low-wage employees during the pandemic).

98. *See id.* ("What are university endowments for, anyway? This debate has become more intense with the arrival of Covid-19 and the accompanying economic devastation.").

a tax on the amount earned through the endowment that exceeds amounts spent on university operations or invested in capital assets that are used towards the university's charitable purposes. Just like the design of the new endowment income excise tax, this policy distinguishes between university assets that are being used for charitable purposes and those that are not. If the university produces income that it then reinvests in investment assets, it will not receive a deduction for those amounts. But investing excess income in new buildings, scientific equipment, or even athletic facilities (as long as those remain under the purview of the university's charitable mission) could all produce immediate deductions. Congress could protect this reinvestment activity by creating an immediate expensing provision for charitable entities that mirrors § 179, but without a dollar limitation.[99] The effect of such a system would be to encourage universities to think hard about the current costs they could cover through spending down investment income. Universities might become more generous with student scholarships or faculty and staff salaries and benefits, or they might invest more in the infrastructure of the university, upgrading office space or dormitories using their investment income. However, universities that do not have any such expenses, or that determine that the benefit of reinvesting their investment income in the corpus of the endowment would outweigh any negative tax implications, would be free to do so. The only cost would be the tax on the income they choose to reinvest.

Some might respond to such a proposal by claiming that it privileges current spending over future spending by taxing universities on their endowment income only to the extent that they do not spend it on current charitable activities. However, the tax code is rife with examples that prioritize current spending over future spending. Indeed, § 179 itself is a tool Congress has used repeatedly to incentivize current spending by businesses in moments that Congress determines that the economy needs a boost.[100] When the economy has suffered a downturn, Congress has not hesitated to offer tax incentives to those businesses in a position to spend as a tool of economic reinvigoration. This is a clear example of preferencing current spending over future spending. Congress can prioritize current spending over future

99. *See* I.R.C. § 179 (2018) (creating an immediate expense for businesses that invest in capital assets up to a certain dollar amount, currently $1,000,000). Without this provision, such amounts would have to be capitalized and recovered over time through depreciation deductions under §§ 167 and 168.

100. *See* Morrow, *supra* note 34, at 23–24.

spending for universities in just the same way.

Some scholars have argued that, for more existential reasons, our tax policy system overall ought to stop prioritizing future spending over current spending and give fewer preferences for savings.[101] Following this line of argument, Congress ought to be incentivizing universities to spend their income now, rather than investing it to produce value for prospective students potentially enrolling in years far into the future. Creating a system that exempts from taxation investment income that is spent for current operations or invested in assets actively used to further the charitable purpose comports with this model. It offers a tax incentive for universities to arrange their affairs in a way that comports with the preference for current charitable activities over future ones.

Some universities might object that their current endowments are not yet large enough to allow them to forgo the reinvestment of income in favor of current spending. Certainly the average endowment of most state schools and many smaller liberal arts colleges is many times smaller than that of the richest schools in the country. The model of taxing endowment income I propose here is consistent with exempting a minimum annual amount of income, permitting every university endowment to reinvest a certain amount of income every year. Alternatively, the model could follow that model adopted as part of the endowment income excise tax, allowing smaller endowments to be entirely exempted from the tax. It does seem that setting the exemption as high as it is currently set has nearly eviscerated the tax, leaving something that affects only a handful of schools every year. To be truly effective, the tax should include an exemption level set significantly lower than it currently is, which would result in an incentive that would affect most universities with endowments large enough to withstand some financial instability.

One important note to make about any such plan to tax the investment income of universities: incurring a tax liability in our system requires that a taxpayer have taxable income. The realization requirement in our income tax system has the effect of exempting from taxation significant amounts of investment growth. Mere appreciation in value is not subject to tax under U.S. tax law.[102] Instead, income is only taxed when it is realized, which, for

101. *See* Buchanan, *supra* note 48, at 1242–43.

102. Appreciation is generally accepted as reflective of true economic income, under, for example, the Haig-Simons definition of income. *See* Joseph M. Dodge, *Deconstructing the Haig-Simons Income Tax and Reconstructing It as Objective Ability-to-Pay 'Cash Income' Tax*, FSU C.L. PUB. L. RES. PAPER NO. 633 1, 1 (2013). For the hallmark United States Supreme Court case confirming the

investment assets, usually means when it is sold. There are obvious exceptions to this rule, most notably stock that produces dividend income, which is taxed when it is received, and interest, rent, and royalty income, which are also all taxed when received. The proposal described in this section might further incentivize investment in growth assets, rather than income producing assets, as universities seek to defer for as long as possible the recognition of income, which would trigger tax consequences. Importantly, though, this is not meaningfully different from the incentives created under the tax system for all investors. The realization requirement has the effect of deferring taxation for anyone invested in growth assets. This policy would merely extend to non-profit entities the same set of incentives currently in place for all taxable investors.

VII. CONCLUSION

The Tax Cuts and Jobs Act is a wide-ranging set of provisions, with the primary consequence of reducing the tax liability of a significant number of individual and corporate taxpayers. One notable exception to the tax cuts offered in the bill was the creation of an excise tax on university endowment income. While there are reasons to be skeptical both about the design of the current tax and of its ability to withstand the political efforts of the powerful set of universities subject to the tax, the excise tax nonetheless opens the door to a discussion of whether it is time to treat universities' endowments more like the private equity funds they increasingly resemble. Perhaps this first move will set the stage for a more robust discussion of the taxation of university endowment income in the years to come.

requirement of realization before income can be subjected to tax, see Eisner v. Macomber, 252 U.S. 189, 214 (1920).

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