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University Endowments: a (Surprisingly) Elusive Concept

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UNIVERSITY ENDOWMENTS: A (SURPRISINGLY) ELUSIVE CONCEPT

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Abstract: Even as certain policy makers press for mandatory payouts from endowments, the concept of an endowment remains surprisingly elusive. In the absence of either operational concepts of endowments or well-established metrics for identifying and measuring endowments, public policy discussions proceed with an implicit model of an endowment as "money in waiting" that is not currently in use for exempt educational purposes. This Article suggests that endowments, however conceptualized or measured, are better understood as "money in use" even though it is not being distributed. It argues that most endowment money is currently in use for at least two purposes. The earnings on endowments are funding both current operations and long-term commitments. The endowment principle itself is used for various forms of credit enhancement for numerous forms of university borrowing. Because the endowment is in use, its distribution would have a far greater impact than policy makers understand.

The Article also suggests that mandatory distributions would have little impact on the public policy issue of access to education. Very few universities have substantial endowments and even fewer have endowments that could make a difference over the long term. Although Congress has the authority to require mandatory distributions as a condition of continued tax exemption, such a requirement has been used only in cases where there was reason to doubt that various types of exempt entities are using their funds for exempt activities. This is not the case with colleges and universities. Recommendations for mandatory distributions do not address any problem with the operation of colleges and universities for exempt purposes and do not offer any realistic hope for a solution of the very serious problem of financing the education and research mission of universities.

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Universities depend fundamentally on government funding in the form of student loans and grants and contracts for research. Universities are "parastatal" enterprises that are publicly funded but privately operated. Much more research is needed on this aspect of university operations and on the actual uses of the endowment that are inconsistent with distribution. Imposing a mandatory distribution requirement on universities is not a substitute for public policies that offer realistic prospects for addressing the problems of access to education by students and adequate funding for research on which our economy and society depend.

INTRODUCTION

Even before the Great Recession, the cost of a college education meant that families made financial sacrifices and students assumed a debt burden that would continue for much of their lives.[1] Tuition increases outpaced increases in the cost of living.[2] This burden on students and their families did not translate into financial strength for colleges and universities.[3] Colleges and universities of all types faced increased costs that tuition revenue did not and could not defray. These institutions embraced fund-raising and revenue-enhancing projects ranging from affinity merchandising, to what they hoped would be high-yield investment strategies, to increased lobbying for government support from state, federal, and even local governments.

The economic downturn that became undeniably clear in September 2008 exacerbated the already substantial problems of students and their families and created additional problems for universities as institutions. The most obvious result of the economic downturn was the reduced return on investments and the loss of invested principle virtually across the board. Public universities lost state support as state tax revenues declined.[4]

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1. For recent perspectives on concerns and discontent over the cost of higher education for students and their families, see a joint study by PUBLIC AGENDA AND THE NAT'L CTR. FOR PUB. POLICY & HIGHER ED., SQUEEZE PLAY 2010: CONTINUED PUBLIC ANXIETY ON COST, HARSHER JUDGMENTS ON HOW COLLEGES ARE RUN (2010), *available at* http://www.publicagenda.org/pages/squeeze-play-2010. For a discussion of the study and of the issues it addresses, see Tamar Lewin, *Study Finds Public Discontent with Colleges*, N.Y. TIMES, Feb. 17, 2010, at A11, *available at* www.nytimes.com/2010/02/17/education/17 college.html.

2. Questions of financing the education mission and the implications for students are analyzed in BURTON A. WEISBROD, JEFFREY P. BALLOU & EVELYN D. ASCH, MISSION AND MONEY: UNDERSTANDING THE UNIVERSITY (2008).

3. *See id.* at 77-86.

4. In addition to quite important reports from particular universities and colleges, NACUBO has made available its annual survey of endowments for the period June 1, 2008 -

Access to both public and private universities was limited as universities faced the need to delay building plans to expand both facilities and faculty. Community colleges reported being unable to serve the needs of current students or to enroll qualified new students. Even elite universities with large endowments announced cutbacks in student aid, including their recently announced programs to offer need-blind admissions.

The Great Recession also meant that research universities, including Harvard, had to scale back plans for new facilities to expand both teaching and research in the sciences. While the government finances much of the research conducted at universities, government financing was not enough in the face of reduced university resources.

Even before the Great Recession, some in Congress raised the possibility of requiring universities to distribute some portion of their endowment earnings to increase financial aid for students. This is an appealing proposal for students, their families, and policy-makers. It holds out the possibility of solving a very serious problem with a policy of redistribution that will not require greater government investment, greater student indebtedness, or greater burdens on American families.

Congress has the authority to require this kind of distribution by tax-exempt universities as one of the requirements for their exempt status. The difficult question is what such a requirement might in fact achieve. This Article does not answer this question. Indeed, the question cannot be satisfactorily answered with current data. This Article focuses on a conceptual framework for thinking about endowments, engaging in research on endowments, and developing policy proposals relating to endowments.

The concept of a university endowment is surprisingly elusive.[5] There are neither concepts of an endowment nor operational definitions of endowments. Further, there are no methods for empirical measurements of endowments using commonly accepted or statutorily defined metrics. In addition, there is a lack of information about which colleges and universities have endowments, however measured, as well as how universities that do have endowments in fact use them. It is not surprising that these empirical and conceptual lacunae are interrelated. These conceptual and empirical lacunae become particularly important in discussions of policy proposals that begin with premises about what is not

June 30, 2009 at its website, http://www.nacubo.org/documents/research/2009_NCSE_Press_Release.pdf.

5. Henry Hansman, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3 (1990) expresses skepticism about maintaining substantial endowments for any reason but concludes that too little is known about endowments to make any recommendations.

yet known and proceed to strong recommendations about distributions from endowments.

This Article begins with a discussion of two general models of endowments. These models shape the general discussion of endowments that follows. Part II raises the question of what types of colleges and universities have endowments and what information is available regarding the size of endowments. Part III raises the question of how endowments are used and discusses the need for better data and more empirical research on this issue. Part IV considers whether mandatory distribution requirement would serve as an effective public policy lever. Part V asks whether tax law principles provide a basis for mandatory distributions from university endowments. The Article concludes by asking what we might learn about exempt entities and the larger issues of exempt status by considering the policy debate over endowments. The Article concludes that the policy leverage that various government officials and commentators have sought by addressing endowments is illusory. This does not mean that addressing these issues is beside the point, only that doing so may well-address a different point. Although at first we find that we think we are dealing with exempt entities in the "independent sector," in the end we find that we are dealing with one enterprise dependent on government financing for both student financial aid and grants and contracts for research. No university has an endowment large enough to alter this fact. The only thing that differs is the degree of dependence. Endowments are useful, but tuition and government support for research are fundamental. Universities are parastatal enterprises heavily dependent on government funding, including, but by no means limited to, exemption from taxation and the deduction available to contributors.

I. Endowments: Models and Their Analytical Implications

Various members of Congress have begun and ended their discussions of endowments with various recommendations and prescriptions relating to distributional issues. This is not a useful place to begin—and may not be a useful place to end.[6] The focus here is why distribution is not a useful place to begin. The more logical and useful place to begin is with two questions: What is an endowment? Why does the answer matter?

Two unarticulated models of an endowment seem to pervade discussions. The first is the model of an endowment as a reserve account that is not being used. An endowment is "money in waiting," found money,

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6. For an insightful analysis of why time value of money concepts are not analytically useful in the discussion of payout rates from exempt entities' endowments, see Michael Klausner, *When Time Isn't Money*, STAN. SOC. SCI. INNOVATION REV., Spring 2003, at 51.

a pot of gold at the beginning of a rainbow that is expected to end in a new and better day. The second model of an endowment is a sum of money that produces income that is allocated to current uses and, in some cases, very likely to multiple uses in long-term budgeting and in securing university borrowing, including bond indentures and other debt covenants. This is a "money in use" model of endowments.

The first model, "money in waiting," makes discussions about distributions both simple and a pressing moral imperative. An endowment is a simple concept. Under this model one need ask only how much money is in the endowment and then make a case for various uses. The money in waiting model simply assumes all of the relevant facts and treats all of the relevant questions as already answered. This model does not provide an analytical framework or help to define research priorities. This is not a model for inquiry, but a model that assumes the time for inquiry is past, if it ever existed. A slightly more useful variant of this model focuses on when distribution should take place, with a debate over current distribution or some consideration for the future might be appropriate. While these questions are important operationally, they cannot be insightfully addressed based on a distributional framework. The central fallacy in the money in waiting model is to equate the use of the endowment with distribution from the endowment. The second model is based on the premise that an endowment is being used even though money is not being distributed from it.

The second model, "money in use," treats an endowment as working capital even though the principle will not be currently distributed. It takes account of the current use of endowment earnings to fund operations. It calls for research focused on university operations and on the operation of the financial markets in which the university must operate to raise capital. It leads to questions about the role of government in providing direct and indirect financial support for universities. It makes discussions about distributions difficult and contingent. Because the endowment is already in use, the discussion focuses not on distribution but on re-allocation. This model of endowments leads to the kinds of questions that should guide both the management of individual institutions and public policy discussions.

The market downturn that became undeniable in late 2008 has made life more difficult for students, faculty, and administrators. Perversely, it should prove useful in persuading both analysts and public officials to reconsider their certainty about the usefulness of the "money in waiting" model and to take another look at the "money in use" model.

There can be no better case studies than Harvard and Yale, the universities with the largest endowments. Both have candidly announced significant cutbacks in their operating budgets and in major projects and have issued updates to their alumni and the public.[7] Neither has made any effort to claim that their programs of student aid and building funds and compensation for administrators, staff, and faculty are unaffected. No one claims that either university will cease to fund classroom education and research. But it is noteworthy that Harvard, to the amusement of many, has lent its good name to a line of clothing that no one who has ever attended Harvard is likely to wear.[8] Monetizing reputational capital is not a broadly applicable solution and may be a bad idea even for Harvard.

Senator Grassley, the ranking member of the Senate Finance Committee, set forth his version of the "money in waiting" model of university endowments in the following terms:

> Tuition has gone up, college presidents' salaries have gone up, and endowments continue to go up and up. We need to start seeing tuition relief for families go up just as fast. It's fair to ask whether a college kid should have to wash dishes in the dining hall to pay his tuition when his college has a billion dollars in the bank.[9]

Senator Grassley characterized donor restrictions on use as "an excuse to hoard rather than spend the money."[10] He observed that "[a]s we say in the nation's capital, money is fungible."[11]

In early 2010, Senator Grassley reminded everyone that he regards endowments as a solution to a problem and the mere fact of the loss of value in endowments is no barrier to increased distributions. As he stated in his press release issued at the same time as the most recent report on endowments, "[a] lot of colleges still have plenty of money in the bank."[12] An endowment appears to be a policy lever that will address important

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7. *See, e.g.*, Kathryn Masterson, *Yale Says Budget Cuts Needed After 25-Percent Drop in Endowment*, THE CHRON. OF HIGHER EDUC., Dec. 16, 2008; Kathryn Masterson, *A Sobering Message from Harvard's President*, CHRON. OF HIGHER EDUC., November 21, 2008.

8. Laurie Fendrich, *My Khakis Went to Harvard*, CHRON. OF HIGHER EDUC., August 7, 2009.

9. Press Release, Sen. Charles Grassley, Stanford's Student Aid Spending May Be Latest Trend, Small Iowa College Offers Examples of Commitment to Students (Feb. 20, 2008), *available at* http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502 =8473.

10. Charles E. Grassley, Commentary, *Wealthy Colleges Must Make Themselves More Affordable*, THE CHRON. OF HIGHER EDUC., May 30, 2008, at A36.

11. *Id.*

12. Press Release, Sen. Charles Grassley, Students, Families Shouldn't Bear Brunt of College Endowment Losses, (Jan. 27, 2010), *available at* http://grassley.senate.gov/news /Article.cfm?customel_dataPageID_1502=24983.

socio-economic-cultural imperatives at no inconvenience to government officials.

Some, including Senator Grassley, have attempted to salvage the primacy of the "money in waiting" model by blaming universities for engaging in risky investment strategies. Senator Grassley said in his January 27, 2010 press release:

> I hope colleges won't rely on double-digit losses as a reason to raise tuition or freeze student aid. Many of them relied on some risky investments, like hedge funds, to get big gains in recent years, and now those strategies are causing losses. Students shouldn't bear the brunt of colleges' easy-come, easy-go investment strategy.[13]

The press release makes no mention of congressional approval of deregulation of financial institutions or Congress's ready agreement with at least two administrations that financial products and purveyors of the more exotic products should not be regulated. There certainly were bad decisions made by universities as well as by all other investors, but these individual failures do not explain the economic crisis and its pervasive effects.

Models are heuristics that highlight elements of a phenomenon and posit relationships among the elements of a phenomenon. Models are elements in building theories and in designing research. Here, the two models of endowments highlight research agendas beginning with the question of how many and what kinds of colleges and universities have endowments, however they are described, measured, or used. The next Part discusses the distribution of endowments, which is analytically prior to any discussion of the distributions from endowments.

II. The Distribution of Endowments

The National Association of College and University Business Officers ("NACUBO") provides an annual survey of college and university endowments.[14] All analyses of endowments rely on these data. NACUBO

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13. *Id.*

14. *See* the NACUBO, Public NCSE Tables, http://www.nacubo.org/Research/NACUBO_Endowment_Study/Public_NCSE_Tables_.html (last visited Apr. 15, 2010). The survey for fiscal year 2009 is the first survey prepared jointly by NACUBO and the Commonfund Institute, which had prepared a separate Commonfund Study of Endowments (NCSE). Press Release, NACUBO-NCSE, NACUBO-Commonfund Press Release on the 2009 Endowment Study Results 1 (Jan. 28, 2010), *available at* http://www.nacubo.org/Research/NACUBO_Endowment_Study/Public_NCSE_Tables_.html. The findings available to the public without charge for fiscal year 2009, which covers July 1, 2008 to June 30, 2009, are available at http://www.nacubo.org/Research/NACUBO_Endowment_Study/Public_NCSE_Tables_.html.

represents over 2100 colleges and universities. Its annual survey of endowments includes 756 colleges and universities. In her important analysis of endowments, Jane Gravelle of the Congressional Research Service concludes that limiting the NACUBO survey to 756 colleges and universities suggests that other colleges and universities have "negligible endowments."[15] This in itself suggests that endowments are heavily concentrated in a relatively small percentage of colleges and universities.

Endowments are largest in the private research universities, lead by Harvard and followed by Yale, Stanford, and Princeton. The largest endowments are measured in billions of dollars. Before the Great Recession, Harvard's endowment was approximately $35 billion, Yale's was $23 billion, Stanford's was $17 billion and Princeton's was $16 billion. The tenth ranked school, Notre Dame, had an endowment of $6 billion, which is certainly a large number, but only seventeen percent of Harvard's endowment.

The smallest endowments before the Great Recession were measured in the millions of dollars, with the ten private colleges with the smallest endowments ranging from approximately $9 million to approximately $6 million.

Jane Gravelle concluded that "[e]ndowment assets are heavily concentrated in a few institutions with large endowments."[16] She found that Harvard alone accounted for 8.5% of the total endowments of the 756 schools included in the NACUBO survey.[17] The top five schools accounted for twenty-five percent of the total endowment of the 756 schools but less than one percent of those schools.[18] The top twenty universities accounted for almost half of the total endowment value but were less than three percent of the 756 colleges and universities surveyed,[19] and less than one percent of the total number of colleges and universities represented by NACUBO. Finally, Gravelle found that the sixty-two colleges and universities with endowments exceeding $1 billion make up eight percent

15. Memorandum from Jane G. Gravelle, Senior Specialist in Economic Policy, Government and Finance Division, Congressional Research Service, to Honorable Max Baucus, Chairman, Senate Committee on Finance & Honerable Chuck Grassley, Ranking Member, Senate Finance Committee on Finance 3 n.2 (Aug. 20, 2007), *available at* http://grassley.senate.gov/releases/2008/01142008.pdf. The Congressional Research Service does not make its reports available to the public but the Reports are not confidential and are routinely cited.

16. *Id.* at 1. This is based on data from the fiscal year ending on June 30, 2006.

17. *Id.*

18. *Id.*

19. *Id.*

of the 756 colleges and universities in the survey but account for two-thirds of the total endowment value.[20]

Burton Weisbrod and his colleagues studied whether management strategies varied with the size of the endowment. It might be reasonable to hypothesize that universities with the largest endowments took more risks because they could absorb losses, while schools with the smallest endowments would seek to protect their principle or could not afford investment advice that took them into the newer, more exotic and riskier investments.[21] Weisbrod found that even colleges with smaller endowments determined that they needed the larger returns that come with higher risks.

The preliminary results from the fiscal year 2009 NACUBO survey found that colleges and universities experienced substantial losses during the period of June 1, 2008 to June 20, 2009.[22] The overall decline in value was twenty-three percent.[23] At the same time, colleges and universities experienced rising institutional debt, with the universities holding the largest endowments also carrying the highest median long-term debt levels.[24] Colleges and universities with the smallest endowments also carried the smallest median long-term debt.[25] It appears likely that schools with smaller endowments experienced difficulty obtaining credit. Overall, the median debt level increased from $28.3 million in fiscal year 2008 to $44.3 million in fiscal year 2009, which is a fifty-seven percent increase in one year.[26]

The studies of endowments make it clear, if only by negative inference, that community colleges operate outside the world of endowments and controversies over endowments. Any serious effort to address the problem of access to higher education must address the financial challenges of community colleges and the students who attend them.

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20. *Id.* at 1-2.

21. WEISBROD, *supra* note 2, at 132-38.

22. Kenneth E. Redd, *Buffeted by Economic Headwinds*, BUS. OFFICER MAG., Mar. 2010, http://www.nacubo.org/Business_Officer_Magazine/Magazine_Archives/March_2010/Buffeted_by_Economic_Headwinds.html.

23. *Id.*

24. *See id.* The median debt for institutions with the largest endowments was $863.1 million. *Id.*

25. *Id.* The median debt for institutions with the smallest endowments was $15.8 million. *Id.*

26. *Id.* The median debt for institutions with the smallest endowments was $15.8 million. *Id.*

III. Uses of Endowments: Issues in Measurement and Analysis

The model of an endowment as "money-in-waiting," a readily available reserve fund, is inconsistent with analyses of uses of endowments as a regular part of college or university operations. The question would be, what conditions might cause a university to dip into this reserve or what kinds of new initiatives might first be funded by endowment reserves. Research would not focus primarily on the current use of endowments. Policy disputes would center on whether either the earnings or the principal of an endowment should ever be used and, if they are used, what kinds of uses are consistent with both sound management and the university's mission. The very idea of an endowment might be thought to be inconsistent with distribution.

The model of an endowment as money in use with particular restrictions and limitations makes research more insightful and policy, ultimately, more effective. The main problem in determining how endowments are used is the lack of systematic data on any element of endowments. Jane Gravelle highlighted this problem in her report on endowments.[27] She reported that information on how endowments are used "is currently voluntary, not always available, and not available in an accessible form."[28] She further observed, "[n]or are measures in place to assure that data are accurate and consistent."[29]

The concept of the use of an endowment is distinguishable from the issue of distributions from an endowment. The existence of an endowment appears to facilitate borrowing by a university. As discussed at the end of this section, a variety of credit enhancement mechanisms are consistent with current law and these mechanisms appear to be used by the better-endowed universities. In addition, the earning from the endowment are part of the regular budget process of most universities. The former president of George Washington University referred to tenure as a bet made by a university that will require that earnings on a stated amount of capital in the endowment be dedicated to paying for that tenure line for the anticipated professional life of the tenured professor. Distributing that amount of capital from the endowment would require that some other source of earnings be identified to pay for the fixed expense of every tenure line in the university budget. The same is true of maintenance and other fixed costs. The concept of an endowment as money in use and the realization

27. Memorandum from Jane Gravelle to Honorable Max Baucus & Honorable Chuck Grassley, *supra* note 15, at 14-15.

28. *Id.* at 14.

29. *Id.*

that use does not necessarily mean distribution at the very least points to more insightful research about university finance.

Current data on the uses of endowments do not capture much of the reality of endowment use. Form 990 now requires that colleges and universities report the amount of their endowments.[30] These changes to Form 990 were finalized and became effective after Ms. Gravelle had completed her report. Under the new reporting requirements on the revised Form 990, the organization is required to report its beginning of the year balance. It is then required to report contributions, investment earnings or losses, grants or scholarships, other expenditures for facilities and programs, administrative expenses, and the year-end balance. Part 2 of Schedule D, Part V requires information on the estimated percentage and balance held in the following three categories: board designated or quasi-endowment, permanent endowment, and term endowment. Part XIV, Supplemental Information, requires a narrative of the "intended uses of the organization's endowment funds." Part 3a of Schedule D, Part V requires information about the "endowment funds not in the possession of the organization that are held and administered for the organization" by unrelated organizations and related organizations.

These questions are potentially quite useful. They should provide information about the apparently common use by public universities of controlled § 501(c)(3) organizations created and maintained to finance expenditures that state legislatures have proved unwilling or unable to fund. Faculty salary supplements are one common use for the amounts raised through controlled § 501(c)(3) organizations.

These questions might also provide information on such structures as Harvard's Management Company, but it is not clear that any of these management companies in fact hold the funds rather than advise on their investment.

This Schedule should provide information not previously available publicly. Current studies of endowments have been conducted by a nonprofit with a proprietary interest in the material that charges a fee for access to most of the data and its analysis. Public availability in itself should facilitate research and policy analysis.

At the same time, there is no statutory predicate that provides comparability in the reports. The terms used are not statutory terms and there is no development of regulations guiding the reporting. The issue is not that the government does not have the authority to collect this

30. IRS Schedule D (Form 990), Supplemental Financial Statements, Part V, Endowment Funds (OMB No. 1545-0047) (2009), *available at* http://www.irs.gov/pub/irs-pdf/f990.pdf. Filing of this form is required if the organization answers "Yes" to Form 990, Part IV, line 10.

information, nor is the issue that organizations will lie, although the reporting positions of some organizations may come uncomfortably close to a lie and unacceptably far from any concept of an endowment. The issue is that there is no way to tell how organizations are allocating funds to their endowments. It is certainly true that all tax returns are based on self-reporting, but the Internal Revenue Code and the applicable regulations provide constraints on interpretation and a basis for determining the acceptability of responses. There are no such restraints in the reporting of endowments in Schedule D, Part V.

The Instructions to Schedule D provide some guidance that is apparently intended to be consistent with current practice in reporting to the private entities that currently track endowments. The lack of conceptual constraint on these ideas applied to particular cases is widely noted. The Instructions also note that accounting standards may affect what is reported. At first blush this might seem unremarkable. Yet, it is quite interesting as a departure from the tax principle that accounting concepts do not control tax reporting. This raises questions about an information return. There is no analogous concept of deference to other statutes in such areas as political activity of exempt entities. The Instructions contain no reference to federal election law, and the extensive reporting requirements applicable under Federal Election Commission regulations.

As is discussed more fully below in the discussions of policy levers, the anomalies of Schedule D, Part V could have greater operational importance if Congress mandates particular uses of endowments and enforces these legislative requirements through excise taxes. In this case, the malleability of definitions would become a serious problem for a tax regime. Colleges and universities would, quite quickly and, one presumes, quite legally, find ways to exclude money from funds that fall within the definition of a fund subject to the tax.

The Senate Finance Committee Roundtable devoted a panel to the question, "What Is an Endowment?" This panel has received little press coverage but should engage our attention. The bottom line point was made by John Mattie, a partner at PricewaterhouseCoopers, who discussed the use of different definitions for endowments by institutions and regulators and the difficulty this poses for policies relating to endowments.[31] He further remarked that aggregating restricted funds in an endowment makes sense for reporting purposes but does not enhance transparency because it can lead to the mistaken view that restrictions do not matter.

Jeff Mechanick, a Financial Accounting Standards Board project manager, discussed FAS 117-1, which provides guidance on reporting and classifying donor-restricted endowment funds and the requirements that

31. See the summary of the September 8, 2008 roundtable at www.case.org.

apply even if the state has not yet adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). He, too, emphasized the heterogeneity of college and university concepts of endowments.

To a tax lawyer, this means that the base amount of a five-percent payout rate is not a stable concept and that considerable issues remain to be addressed in making this an operational concept. Jane Gravelle of the Congressional Research Service asked the critical question of the accountants. She asked whether, if Congress enacted the proposed mandatory payout, colleges and universities could shift funds to accounts that are not considered part of the endowment. Both accountants replied that this would be possible. Both also stated that many colleges and universities invest non-endowment funds with endowment funds.

Even if these issues relating to the definition and measurement of an endowment were to be resolved in a way that created a stable, administrable reporting regime, this would not permit an informed decision about mandatory distributions. Any serious effort to develop a proposal for requiring distributions from college and university endowments would require a serious study of how educational institutions are using their endowments. This kind of study would not conflate use with distribution. The possibility of use without distribution is rarely considered and no data are available on this concept of use of an endowment. Critical questions would be whether, to what extent, and in what ways endowments enable in loan documents, and whether mandatory distributions would be inconsistent with these credit enhancement mechanisms.

These questions are not discussed for two main reason. One is that research would require going beyond the NACUBO data and the data that will now be publicly available on Form 990 and actually persuade universities to allow researchers to examine their credit agreements and other relevant documents. This would not be an easy task.[32] It may well call for collaborative research between exempt organization lawyers and lawyers specializing in finance. The second reason is that tax lawyers are inclined to believe that universities and other exempt entities borrow only by issuing bonds and that tax law imposes prohibitive taxes on the use of endowment funds to support bond issues. This is an easier barrier to overcome because it is simply incorrect. An April 2010 report from the Congressional Budget Office supports the broad concept of use without distribution discussed here and helps clarify the law in this area.[33] Colleges

32. Henry Hansmann, *supra* note 5, at 3 n.*, in the introductory note reported that "The Yale University Treasurer's Office gave generous assistance in interpreting the university's financial records." It is unclear precisely what records were involved, but very few researchers have sought such access and very few entities have responded cooperatively.

33. *See generally* CONGRESSIONAL BUDGET OFFICE, TAX ARBITRAGE BY COLLEGES AND

and universities with large endowments also tend to borrow by issuing tax-exempt bonds. This results in "tax arbitrage" when the rate the universities pay on the bonds issued is less than the rate earned on the endowment. Section 148 of the Internal Revenue Code of 1986, as amended, addresses "arbitrage bonds" by imposing yield restrictions through a "replacement proceeds" analysis. However, as the CBO Study notes, this system does not work well and affords numerous opportunities for circumvention. The CBO points out:

> Because financial statements typically do not report the use of particular assets as collateral, the replacement proceeds rule is difficult to enforce. In addition, if assets are not specifically pledged to pay the debt service on a tax-exempt bond or if the assets have no other direct connection to the bonds, the arbitrage restrictions do not apply. However, it is widely recognized that assets and their earnings can be used to pay the interest on debt or to cover other expenses to free up funds for interest payments, regardless of whether they are directly pledged to do so. Such use of higher-yielding assets to finance tax-exempt debt constitutes indirect tax arbitrage.[34]

The CBO also observed that "[i]t is also standard practice for rating agencies to base credit ratings for a particular debt issue on all available assets, not just on those directly pledged to that debt issue."

These uses of the endowment are likely to be widespread. Universities do not borrow only through tax-exempt bonds. Like any other large enterprise, universities have cash management strategies and various lines of credit from a variety of lenders. The uses of the endowment in relation to these credit arrangements have yet to be researched and analyzed and taken into account in public policy discussions.

IV. Would Distribution Requirements Serve as an Effective Public Policy Lever?

Distribution requirements might be considered important from at least two perspectives. First, requiring distributions might rationally be considered evidence that colleges and universities are operating for their exempt purpose of education.[35] Second, a distribution requirement might be

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UNIVERSITIES (2010), *available at* http://www.cbo.gov/ftpdocs/112xx/doc11226/04-30-TaxArbitrage.pdf.

34. *Id.* at 7.

35. For a discussion of the enumerated exempt purposes in § 501(c)(3), including education, see FRANCES R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS (2002) at Chapter 3.

targeted to address a broader public policy issue. In this case, the escalating cost of higher education in the global economy depends increasingly on well-educated workers for all sectors of the service economy at the very time that students and families have difficulty paying the costs of education. It should not be necessary to observe that this is a broad and fundamental issue. It is certainly an issue that extends well beyond the question of requiring that colleges and universities distribute a prescribed portion of their endowments annually. In this sense, a minimum distribution requirement for colleges and universities is akin to the community benefit standard for hospitals. In that long-running controversy as well, the issue of whether exempt entities are operating to provide a public benefit has been conflated with the issue of using exempt entities to solve difficult public policy issues. Conflating a public benefit requirement with a public policy response does not produce useful public policy proposals. Indeed, calls for mandatory distributions from endowments may impede, whether intentionally or unintentionally, serious efforts to craft public policies.

The controversy over the community-benefit standard and exempt hospitals differs from the controversy over minimum distribution requirements for colleges and universities in ways that help explain the distinction between the public-benefit concept and the public policy concept. Health care is not an enumerated exempt purpose in section 501(c)(3).[36] This means that hospitals that choose to operate as exempt entities will rely on charity as their exempt purpose. An element within the definition of charity is relief of the poor and distressed. This means that exempt hospitals are initially required to satisfy a charity care standard that, over time, became a more inclusive community benefit standard. In addition to showing that they operate exclusively, which has come to be defined as primarily, for a public benefit, exempt hospitals also have to satisfy a separate community-benefit standard. It is scarcely surprising that confusion and controversy ensues. The community benefit standard is part of the public-benefit requirement for exemption. No one has been willing to argue expressly that the profound issues surrounding health care would be solved if exempt hospitals provided more community care or if a more stringent charity care or community-benefit requirement were imposed as a condition for exemption. In sum, the controversy over exempt hospitals is whether they are exempt and what criteria should be applied to make this determination.

The controversy over proposals for a university endowment distribution requirement is not in response to questions of whether colleges

36. For a discussion of the community benefit standard and exempt status for hospitals, see *id.* at ¶ 3.02[5] and ¶ 29.04[3].

and universities are operating for an exempt purpose. It is instead a controversy over how to increase access to the exempt activity in which colleges and universities are clearly engaged. It is a controversy over the underlying public policy issue of supporting basic research and developing a workforce equipped to contribute to the economy of the twenty-first century. Put in the broadest possible terms, this is a controversy over the relative responsibilities of students and their families, colleges and universities, and the American people acting through their government to ensure that education is broadly available. The question then becomes not whether a distribution requirement for more financial assistance for students would solve the underlying problem, but whether it would contribute meaningfully to it. The other question is whether public officials' focus on the duty of the colleges and universities themselves serves a useful public policy purpose, or whether it simply obscures the insufficiency of the government's contribution to ensuring that universities can operate efficiently to help students gain access to higher education. What might a distribution requirement achieve?

The previous discussion of the limited number of colleges and universities that have endowments of any meaningful size; the idea that endowment funds are not a reserve but are funds already in use to sustain universities' education missions; and the lessons that appear to be emerging from the experience with the Great Recession, all suggest that a mandatory distribution requirement would have a limited impact. The absence of a statutory definition of an endowment for tax purposes also suggests that administering such a requirement might prove challenging in ways that would limit the requirement's effectiveness.

Jane Gravelle's 2007 memorandum has been widely cited and, in some cases, misunderstood.[37] It is important to note that the data used for this study was for the fiscal year ending in June 2006.[38] She concluded, based on her sample, that a fairly minimal increase in endowment payouts by the institutions in her sample would alleviate the pressure of tuition increases, but she was very careful to state that this conclusion applied to the twenty universities and ten liberal arts universities with the largest endowments.[39] She also concluded that the results were "not as pronounced" for the sixty-two institutions with endowments of over $1 billion, but, here too, increased payouts could replace tuition increases and "increase[] student aid significantly."[40] That is the good news. This good

37. *See generally* Memorandum from Jane Gravelle to Honorable Max Baucus & Honorable Chuck Grassley, *supra* note 15.

38. *Id.*

39. *Id.* at 2.

40. *Id.*

news must be put in the context of the heavy concentration of endowment funds.[41]

The news about endowments became decidedly more mixed in subsequent years. As discussed in Part II, the Great Recession resulted in substantial declines in endowment values and increases in debt held by colleges and universities. As discussed in Part III, colleges and universities experienced liquidity crises during the Great Recession. Many universities increased their endowment spending, including public universities that required amendments to state laws permitting them to do so. These developments suggest that the current understanding of the uses of endowments may well be incomplete and, thus, somewhat misleading. Liquidity issues and increased borrowing by universities with large endowments suggest that such universities were acting in response to constraints on current use of their endowments. One possible explanation is that endowments are used not simply for expenditures that can be traced, but also for credit enhancement provisions that support borrowing or that support favorable rates on borrowing by their students. If endowments fall below levels required in these credit enhancement clauses or student loan rate agreements, default clauses or other clauses requiring substitution of collateral may take effect. These possibilities suggest that policy proposals relating to mandatory distributions would benefit from greater information about this kind of use of endowments in sustaining college and university operations.

Proposals for mandatory distributions from endowments do not seem likely to address the high cost of access to higher education or the high costs of operating colleges and universities. At the same time, it is difficult to argue that colleges and universities are not operating for an exempt purpose. Even if one could identify universities with large endowments that are using a smaller percentage for student financial aid than are universities with small endowments, it would be difficult to argue that they are serving educational purposes less effectively than those schools using a slightly larger percentage of their endowment for student aid. In other words, there are well-founded reasons for scepticism that mandatory distributions from endowments are either meaningfully related to serving an exempt educational purpose or to addressing the larger underlying public policy issue. Conflating the public policy issue with the exemption standard serves only to confuse both issues. The most serious result of such confusion is to divert attention from the duty of the public, acting through their government, by holding out a hollow promise offering only an illusory solution to the problem of access to higher education.

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41. *See supra* Part II.

V. Do Tax Concepts Support the Concept of Mandatory Distributions?

Nothing in the Internal Revenue Code[42] compels any particular level of distributions from college and university endowments. However, certain provisions have been invoked in support of current proposals for mandatory distributions from college and university endowments, making brief discussions of these provisions helpful in addressing the issue of whether tax law requires distributions as a condition of exempt status.

The private foundation provisions include a mandatory distribution requirement that has been invoked in the discussion of mandatory distributions from college and university endowments. Section 4942 imposes a tax on undistributed income[43] and defines undistributed income in terms of investment earnings.[44] The minimum distribution requirement does not apply to private operating foundations.[45] The private foundation provisions also include an excise tax on net investment income.[46] This provision, too, contains an exception for private operating foundations.[47]

The private-foundation provisions reflect concerns that private foundations were operating for the benefit of the contributors who control them. The central distinction between private foundations and public charities, like colleges and universities, is the limited number of contributors to private foundations. Because there are no prohibitions on having the contributors serve on the boards of the private foundations, the fear is that the private foundation will serve the interests of the contributors who also control the board of directors. There are similar concerns with other provisions applicable to private foundations but not to public charities.[48] The § 4946 conflict of interest provisions applicable to private foundations prohibit certain transactions rather than focusing on whether the pricing of these transactions between an exempt organization and disqualified persons are conducted on the basis of reasonable prices.

The pricing of these transactions is part of a larger discussion of the relation between private foundations and public charities. This discussion

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42. *See generally* Internal Revenue Code of 1986, as amended (codified at 26 U.S.C. § 1 et seq).

43. I.R.C. § 4942(a)-(b) (2006).

44. § 4942(c)-(d).

45. § 4942(j)(3).

46. § 4940, which is discussed in detail in HILL & MANCINO, *supra* note 35, at ¶ 12.02.

47. § 4940(d).

48. See the excess business holdings of § 4943, which are discussed in HILL & MANCINO, *supra* note 35, at ¶ 12.03; the jeopardizing investment provisions of § 4944, which are discussed in HILL & MANCINO, *supra* note 35, at ¶ 12.04; and the self-dealing provisions of §§ 4941, 4946, which are discussed in HILL & MANCINO, *supra* note 35, at Chapter 10.

has centered on the application of § 4958 excess-benefit transactions to private foundations in place of the restrictive self-dealing concepts.[49] The general trend of the discussion suggests that private foundations should be able to avail themselves of the facts-and-circumstance approach of the excess-benefit-transaction provisions applicable to § 501(c)(3) public charities and § 501(c)(4) social welfare organizations. Whether this suggestion has merit in terms of appropriate requirements for exempt status is beyond the scope of this essay. What is clear is that provisions applicable to private foundations limit conceptual utility when applied to public charities that do not operate in the context of the kind of contributor control that accounts for most of the private foundation provisions.

The Pension Protection Act of 2006[50] directed Treasury to promulgate regulations requiring certain supporting organizations to make mandatory distributions to the supported organization to which they are not functionally related.[51] The proposed regulations are modeled on the private foundation minimum distribution requirements.[52] The purpose of this payout requirement is to ensure that the non-functionally related supporting organization distributes sufficient amounts to sustain its claim to exempt status based on its relationship with the supported organization. This is a very different purpose than the purpose of addressing a public policy issue of access to education. There is no question that colleges and universities are operating for an exempt educational purpose.

Taxable entities are also subject to a limited number of provisions designed to prevent excess accumulation of earnings. The concern here is that corporations will become unregulated mutual funds that operate primarily by investing retained earnings and do not distribute their earnings to their shareholders, thereby avoiding the shareholder-level tax. Section 532(a) imposes a tax on accumulated earnings. Section 533 provides that this accumulated earnings tax applies only to earnings and profits accumulated "beyond the reasonable needs of the business." This standard has provoked a wide range of disputes between corporate taxpayers and the I.R.S., but the I.R.S. has been, in general, quite receptive to arguments establishing a reasonable business purpose for the accumulation of earnings

49. The private-benefit doctrines, including the § 4958 excess-benefit transaction rules, applicable to public charities are discussed in HILL & MANCINO, *supra* note 35, at Chapter 4.

50. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1241(d)(1), 120 Stat. 789.

51. *See* I.R.C. § 509(a)(3)(B). For a discussion of supporting organizations, *see* HILL & MANCINO, *supra* note 35, at ¶ 8.06.

52. Prop. Treas. Reg. § 1.509(a)-4. The proposed regulations have attracted substantial adverse comment. *See, e.g.*, *ABA Members Comment on Proposed Regs on Type III Supporting Organization Qualifications*, TAX NOTES TODAY, Apr. 29, 2010, 2010 TNT 82-14.

and profits. The second provision is the personal-holding-company tax of § 541, which is more likely to be imposed in the case of small, closely held corporations.

Colleges and universities do not present the same concern that the entity will avoid distributing earnings to shareholders in an effort to avoid taxation at the shareholder level. Exempt organizations do not have shareholders with a right to receive dividend distributions. In addition, these provisions do not seem designed to serve the underlying public policy goal of increasing access to education.

CONCLUSION: ENDOWMENTS AND EXEMPTION

Considering the idea of a mandatory distribution requirement suggests that this proposal is not a viable public policy response to the underlying issue of affordable access to higher education. Whether Congress wishes to make such distributions a condition for exemption in the case of those colleges and universities that have endowments of any size is a different matter and not one that has been the focus of this Article.

It is certainly unusual to introduce new ideas in a conclusion, but that is where the analysis has lead. Any public policy response to a public policy issue will necessarily involve government funding for student financial assistance. The same is true for pursuit of universities' roles in basic and applied research. Tuition cannot support universities, and students should not be expected to pay the full cost of operating a university that provides appropriate public benefits to many sectors of society.

What one learns most clearly by considering endowments is that it is time to reconsider what it means to treat both universities and hospitals as § 501(c)(3) organizations subject to the same legal regime as that applied to all other public charities. Both are highly dependent on government financing. Students could not pay tuition without government programs. Universities could not meet their operating expenses without government grants. Universities lobby actively for government funding.[53] Universities are closer to parastatal enterprises than they are to traditional public charities that receive contributions and provide public benefits to a charitable class. It is time for the exempt status of universities (and hospitals) to reflect this status. It is a far better use of the time and resources of the tax-writing committees of Congress than crafting proposals for mandatory distributions from endowments.

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53. For a detailed account of lobbying by colleges and universities, see generally ROBERT G. KAISER, SO DAMN MUCH MONEY: THE TRIUMPH OF LOBBYING AND THE CORROSION OF AMERICAN GOVERNMENT (2009).