ARNOLD VENTURES

Taxing University Endowments is a Step Toward Parity Treatment of Investment Income

AV Issue Brief

Prior to the 2017 Tax Cuts and Jobs Act, the endowment income of private and public universities was entirely tax-exempt. Donors could deduct the contributions they made to endowments, but universities paid no tax on the donations they received. These tax-free dollars were then invested, and no tax was paid on the endowment's returns. In effect, endowment returns were triple-non-tax income.

TCJA imposed a 1.4 percent excise tax on the investment returns of certain private university endowments. Eligible endowments were those in which the university had more than 500 students and the endowment held assets greater than $500,000 per enrolled student. The 1.4 percent tax rate is comparable to the 1.39 percent tax rate paid by private foundations on their investment returns. The tax is considered an excise tax, not an income tax.

The House Ways and Means Committee is said to be considering a proposal to raise the tax on endowments to 14 percent. Separately, Rep. Troy E. Nehls (R-T.X.) has introduced legislation that would increase the current 1.4 percent excise tax on the investment income of eligible university endowments to 21 percent, the same rate corporations pay on their investment income. Sen. Tom Cotton has introduced a bill to levy a one-time 6 percent tax on the 2024 value of the endowments of 11 universities.

Here are some issues to consider as lawmakers debate this policy:

TAXING THE RETURNS TO ENDOWMENTS IS LIKE TAXING THE WITHDRAWALS FROM INDIVIDUAL 401K'S.

Like endowments, individual 401k investments are made with pre-tax, or tax-exempt, income. Individuals pay tax on the investment build-up within their 401k account when they withdraw their funds in retirement. The principle that applies to taxing withdrawals from individual 401k accounts should apply to university endowments. Thus, the investment income earned by endowments should be taxed in the same manner as withdrawals from individual 401k accounts.

Universities will say that the returns from their investments should be exempt from tax because they are used for charitable purposes, such as student scholarships. But the needs of students seem hardly more important than the needs of retirees who must rely on their investment income to pay for food, clothing, and housing costs.

UNIVERSITY ENDOWMENTS ARE LARGE AND HAVE BEEN GROWING.

The 2024 NACUBO-Commonfund Study of Endowments reports the results of their annual survey of US and Canadian public and private university endowments. For our purposes, we've excluded the Canadian schools from our data and analysis.

The 2024 study provides information on the endowment activities of 654 US public and private college and universities. Overall, these endowments reported $871 billion in total assets, an increase of $54.5 billion above 2023 levels. The average university endowment was $1.33 billion, up from $1.24 billion in 2023. There were 143 endowments with more than $1 billion in assets.

University endowments have grown substantially over the past decade. Between 2014 and 2024, the market value of US college and university endowments grew 71 percent, from nearly $508 billion to $871 billion. The average university endowment more than doubled in size, from $627 million in 2014 to $1.33 billion in 2024.

Private college and university endowments compose the majority of endowments in the NACUBO-Commonfund survey. There are 387 private university endowments surveyed in the study. In 2024, they managed total assets of $583.6 billion, an increase of $31.6 billion above 2023 levels. The average size of private endowments was $1.5 billion. There were 89 private university endowments with more than $1 billion in assets and 16 with assets greater than $10 billion.

Table 1. The Top 10 Private University Endowments Held $272 Billion in Assets in 2024, One-Third of all Endowment Funds

University Name	FY24 Total Endowment Market Value (in $billions)	FY23 Total Endowment Market Value (in $billions)
Harvard University	$51.98	$49.50
Yale University	$41.44	$40.75
Stanford University	$37.63	$36.50
Princeton University	$34.05	$34.06
Massachusetts Institute of Technology	$24.57	$23.45
University of Pennsylvania	$22.35	$20.96
University of Notre Dame	$17.90	$16.62
Columbia University	$14.78	$13.64
Northwestern University	$14.21	$13.70
Johns Hopkins University	$13.06	$10.54

Source: 2024 NACUBO-Commonfund Study of Endowments, https://www.nacubo.org/Research/2024/NACUBO-Commonfund-Study-of-Endowments

THE CURRENT EXCISE TAX RAISES A SMALL AMOUNT OF REVENUES FROM A FEW ENDOWMENTS.

Recent data from the IRS Statistics of Income (SOI) shows that 56 universities paid the excise tax in 2023, compared to 58 in 2022 and just 33 in 2021. These 56 universities paid a total of $380 million in excise taxes on their endowment income. We estimate that these excise taxes were paid on roughly $17 billion in investment income.

Below we can see that the number of endowments that have paid the excise tax has fluctuated from year to year. SOI did not report figures for years before 2021 out of privacy concerns for the few number of universities that paid the tax. Information on which universities paid the tax is not available since the tax is paid on IRS Excise Tax Form 4720 rather than on the public 990 income tax form.

Table 2. A Small Number of Private Universities Have Paid the 1.4 Percent Excise Tax

	2023	2022	2021
Number of Colleges or Universities	56	58	33
Amount of Tax Paid	$380,934,219	$243,710,847	$68,088,096

Source: https://www.irs.gov/statistics/soi-tax-stats-charities-and-other-tax-exempt-organizations-statistics. Table 1. Excise Taxes Reported by Charities, Private Foundations, and Split-Interest Trusts on Form 4720

ENDOWMENT EARNINGS GREATLY EXCEED ENDOWMENT PAYOUTS.

Universities claim the tax denies them funds that could be spent on scholarships and facility improvements. But NACUBO data shows that private university endowments have enjoyed 6.9 percent annualized rates of return on their investments over the past decade, although endowments larger than $5 billion have enjoyed average returns of 9.2 percent. Meanwhile, the typical private university spends just 4.7 percent of their endowments annually toward operations and student subsidies, meaning there is a large gap between what universities earn on their endowments and how much they share with students.

LARGER ENDOWMENTS HAVE NOT NECESSARILY LED TO LOWER TUITION AND COLLEGE COSTS.

Prior to the COVID-19 epidemic, the cost of private universities was rising at a rapid rate. According to the National Center for Education Statistics, the total cost of tuition, fees, room and board for all private colleges and universities grew by 20 percent in nominal terms between the 2013-2014 school year and the 2018-2019 school year. The increase was 10 percent after adjusting for inflation.

College costs have moderated since COVID thanks to increased government aid and lower demand. In 2023, the total cost of private universities was 30 percent higher than in 2013, in nominal terms, 2 percent higher after adjusting for inflation.

UNIVERSITIES FUND EXPANSION THROUGH CHEAP BORROWING RATHER THAN BY DRAWING FROM THEIR ENDOWMENTS.

Because universities can borrow at interest rates lower than the returns they generate on their investments, they rely on borrowing (often using tax-exempt municipal bonds) to fund expansion and infrastructure needs rather than draw from their endowments.

According to a recent academic study by economists Matteo Binfarè and Kyle E. Zimmerschied, "the average issuance yield of university bonds is 4.67 percent." So, it is not surprising that universities prefer to use cheap borrowed money to expand campus amenities rather than draw down on endowments earning roughly 7 percent annually.

The rules governing muni bonds prohibit outright arbitrage—using cheap borrowed money to invest—but money is fungible, and the availability of taxpayer-subsidized bonds has created a moral hazard.

Colleges and universities sold $24 billion in tax-free muni bonds in 2024 according to Bloomberg, including universities with some of the largest endowments in the nation. This includes Columbia, Cornell, Princeton, Harvard, and the University of California.

In their study, Binfarè and Zimmerschied also report that total university bond issuances (municipal and private) have increased from about $3 billion in 1985 to a peak of nearly $60 billion in 2019. Indeed, they estimate that in 2020 "the average university paid approximately $1,000 per student in interest expenses, whereas the average in-state tuition for in-state students at public universities was $10,000 per year."

CHEAP BORROWING HAS RAISED COSTS AND HAS NOT IMPROVED EDUCATION QUALITY.

Independent research has found that the increased reliance on debt has contributed to the rising cost of higher education. Moreover, the amenities that universities have funded with debt have not improved the quality of higher education.

Binfarè and Zimmerschied found that universities are not taking on debt to expand facilities in response to growing student enrollment, but instead to improve "dormitories, parking garages, athletic facilities, or student centers." They determined that "universities have increasingly used debt as a tool to cater to student demand for increasing amenity quality, with no evidence of spillovers to education quality."

UNIVERSITY ENDOWMENTS HAVE BECOME TAX-EXEMPT HEDGE FUNDS.

Like most investors, university endowments maintain an investment split of roughly 75 percent equities and 25 percent fixed income, which includes bonds and real estate. However, the NACUBO data shows that as endowments get larger, the more they invest a disproportionate share of their assets in private equity, private venture capital, and alternative marketable investments—which could include hedge funds, commodities, and cryptocurrencies.

For example, the NACUBO data shows that in 2024, public and private endowments with more than $1 billion in assets invested 10.2 percent of their funds in dedicated US equities, compared to 14.1 percent in private venture capital, 19.5 percent in private equity, and 18.3 percent in alternative marketable investments.

Private university endowments tend to mirror this alternative investment approach. The 2024 data show they invested 7.9 percent of their assets in dedicated US equities, but 13.4 percent in venture capital, 18.3 percent in private equity, and 17.5 percent in alternative investments.

UNIVERSITIES ARE ALSO HIGHLY SUBSIDIZED THROUGH OTHER CHANNELS, SUCH AS CHARITABLE DONATIONS.

Private universities operate in a largely tax-free world. Indeed, they may be some of the most tax-exempt sectors in the economy.

As tax-exempt organizations, universities can receive tax-deductible donations, but contributions compose less than 20 percent of the total income for the average university. However, according to the Joint Committee on Taxation (JCT), the tax-exempt value of the charitable donations to educational organizations is roughly $14 billion annually, or $68.5 over five years.

Most university income comes from tuition, fees, cafeteria proceeds, dorm payments, investments, ticket sales, TV broadcast revenues, government grants, and royalties, all of which are exempt from tax but would be taxed if earned by a commercial enterprise. Universities are also typically exempt from local property taxes and, as we've seen, can tap tax-exempt municipal bonds. And, as tax-exempt entities, they pay less in postage costs.

UNIVERSITY ENDOWMENTS AREN'T HELD TO THE SAME RULES AS PRIVATE FOUNDATIONS.

Private foundations are required to pay out 5 percent of their assets each year or pay a penalty. Data shows that private universities typically pay out less than that—4.7 percent on average over the past decade. NACUBO data shows that private universities paid out 5 percent or more toward operations and student assistance in only three years out of the past ten—2021, 2023, and 2024—but were not required to do so.

INCREASING THE EXCISE TAX ON UNIVERSITIES CAN RAISE SUBSTANTIAL SUMS FOR DEFICIT REDUCTION OR TO OFFSET TAX RELIEF FOR AVERAGE AMERICANS.

Tax Foundation economists estimated the amount of new tax revenues that could be raised by increasing the excise tax rate from 1.4 percent to 21 percent based on different assumptions of the rate of return earned by these endowments. For example, assuming a mid-range annualized rate of return of 7.5 percent, economists estimate the 21 percent tax rate could raise $70 billion over the next decade. Assuming a lower 5 percent rate of return could generate $38.5 billion, while assuming a higher 10 percent rate of return could generate more than $112 billion over a decade. Their estimate does not assume any changes in the eligibility thresholds of the tax.

Table 3. Taxing Endowments: Revenue Analysis of an Endowment Tax

Revenue Effect (Billions of Dollars)	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-2034
Revenue assuming a 5% annual return	$3.10	$3.20	$3.40	$3.50	$3.70	$3.90	$4.10	$4.30	$4.50	$4.80	$38.50
Revenue assuming a 7.5% annual return	$4.90	$5.30	$5.70	$6.10	$6.60	$7.10	$7.60	$8.20	$8.80	$9.50	$69.80
Revenue assuming a 10% annual return	$7.00	$7.70	$8.50	$9.40	$10.30	$11.30	$12.50	$13.70	$15.10	$16.60	$112.30

Source: Tax Foundation: Taxing Endowments: Revenue Analysis of an Endowment Tax

WHAT OTHER REFORMS SHOULD LAWMAKERS CONSIDER?

First, for the sake of public transparency, universities should have to report the amount of endowment tax they pay on their 990 tax return. Currently, the tax is reported on a separate 4720 Excise Tax form, which is not publicly available and, thus, hidden from the view of donors. Including this information on the public 990 tax return would better inform donors of any liability the university may have.

Next, lawmakers should consider requiring university endowments to pay out at least 5 percent of their assets annually, as is required of private foundations. This requirement would equalize the treatment of similar types of entities and prevent the amassing of endowment funds without benefiting students.

Lastly, lawmakers could consider tightening the arbitrage rules governing municipal bond funds to discourage universities that may be tempted to excessively rely on tax-exempt borrowing to fund facility improvements rather than dip into their growing endowments.

SOME FINAL WORDS OF CAUTION.

A narrowly focused excise tax on such a small group of university endowments does violate the basic principles of tax neutrality. Ideally, any tax should be applied equally across similar entities and taxpayers. But the tax code does not tax investment income uniformly across individuals, businesses, or nonprofit entities, and this can create the impression of unfairness as well as harmful economic consequences.

In a truly perfect tax world, if investment income is to be taxed at all, then all investment income should be taxed at the same rate regardless of whether it is earned by an individual, business, or nonprofit entity.

In addition, given the multiple legislative proposals and regulatory actions impacting higher education these days, these new ideas should be explored with an eye towards the revenue they would raise, as well as in the context of other changes that may impact university finances and operations, such as decreases in research overhead rates.

And finally, these proposals should not be confused with recent targeted efforts to punish specific universities for reasons unrelated to improving our system of higher education finance – reasons such as culture war disputes and foreign policy goals. It would be a shame indeed if such targeted efforts tainted proposals to reform higher education to provide a higher-quality, lower-cost product to students by reducing waste and inefficiencies in the system.

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