



Tax Primer:

**A Brief Introduction to Higher
Education Tax Policy Issues**

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Introduction

This primer, a follow-up to NACUBO's 2017 *Tax Reform: A Call to Action for Colleges and Universities*, is designed to provide a brief overview of tax issues under consideration and scrutiny in the nation's capital. The 2017 Tax Cuts and Jobs Act brought many of these issues to the forefront of debate on Capitol Hill. And, following passage of the legislation, questions remain: How will IRS and Treasury guidance change our understanding of these policies? Will Congress take action to undo some of the provisions that have proven unpopular? What can colleges and universities do to enhance public understanding of nuanced and complicated issues?

NACUBO urges business officers to use this document to begin conversations with fellow administrators, campus government relations and communications officers, and others about how tax policy impacts everyday interactions with students and employees, and discuss how seemingly small changes can impact major strategic financial decisions. We urge you to consider your institution's tax priorities, and ensure presidents, chancellors, and trustees are well-versed in what these issues mean to your students, staff, and campus community.

While NACUBO does not expect action on tax legislation on the order of magnitude of the 2017 Tax Cuts and Jobs Act in the near future, it is possible that lawmakers could take action on some of these issues in weeks and months to come. Other issues, like college and university endowments, have been under scrutiny by some lawmakers for more than a decade, and are expected to remain so.

About NACUBO:

The National Association of College and University Business Officers (NACUBO), founded in 1962, is a nonprofit professional organization representing chief administrative and financial officers at more than 1,900 colleges and universities across the country. NACUBO's mission is to advance the economic vitality, business practices, and support of higher education institutions in pursuit of their missions.

QUESTIONS?

Contact NACUBO's federal affairs team at advocacy@nacubo.org.

CHARITABLE GIVING

Charitable donations help colleges and universities achieve their teaching, research, and public service missions. For the past 100 years, the charitable deduction has encouraged individuals to make significant, transformational gifts to educational institutions.

It is unlikely that the government could find a more efficient way to leverage private investment than with the charitable deduction. With limited funding from federal and state governments and pressure to limit tuition increases, raising private support is crucial for colleges and universities.

From small colleges to large universities, charitable giving helps fuel commitments to provide an affordable, quality education.

Changes to Charitable Giving in the Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act effectively doubled the standard deduction, and in so doing, effectively eliminated the charitable deduction for millions of taxpayers who will no longer itemize their tax returns. This change is projected to significantly diminish giving to all nonprofit organizations, including colleges and universities.

Numerous studies, including one from The Joint Committee on Taxation (JCT) and another by Indiana University's Lilly Family School of Philanthropy and the Independent Sector, have estimated that the changes to the standard deduction as passed in the Tax Cuts and Job Act will spur a dramatic drop in the amount of charitable giving in the U.S. JCT estimates that 28.5 million fewer tax payers will be eligible to claim the charitable deduction in 2018 (because they will not itemize their tax returns). Additionally, since the value of the charitable deduction is tied to a taxpayer's marginal tax rate, tax rate cuts automatically increase a donor's cost of giving.

Several lawmakers in the 115th Congress introduced legislation to rectify the problem by proposing a universal charitable above-the-line deduction that would be available to all taxpayers.

- **H.R. 3988 / S. 2123: Companion bills introduced by Rep. Mark Walker (R-NC) in the House and Sen. James Lankford (R-OK) in the Senate would extend the charitable deduction to all taxpayers, including those who do not itemize, but would limit the deduction they could take to up to one-third of the value of the standard deduction.**
- **H.R. 5771: Introduced by Rep. Chris Smith (R-NJ) this bill would extend the charitable deduction to all taxpayers without imposing any limit on the value of the deduction.**

The Tax Cuts and Jobs Act also:

- Repeals the special rule that provides a charitable deduction of 80 percent of the amount paid for the right to purchase tickets for athletic events.
- Increases the 50-percent limitation for cash contributions to public charities and certain private foundations to 60 percent.
- Establishes new requirements for donor-advised funds.
- Preserves the estate tax but doubles the exemption level—fewer individuals will pay the tax, and they will pay less.

NACUBO is a member of the **Charitable Giving Coalition**. Formed in 2009, the Charitable Giving Coalition's members include more than 60 diverse organizations representing private and community foundations, their grantees and independent charities, as well as nonprofit organizations and the associations and umbrella groups that serve their needs. The Coalition is dedicated to preserving the charitable tax deduction, which is crucial to ensuring our nation's charities receive the funds necessary to fulfill their essential philanthropic missions. The Coalition provides a unique and unified voice on Capitol Hill, including lobbying and grassroots advocacy, on issues affecting the charitable deduction. **@protectgiving #protectgiving**



ENDOWMENTS

At postsecondary institutions, endowments are critical for student financial aid (scholarships), but they also serve as funding sources for faculty, libraries, laboratories, campus housing, student services, and other components that are key to a student's education. Endowments also support research and public service missions, such as innovations in nanotechnology, medical research, or university-based youth and community development programs.

In recent years, lawmakers and others have focused their concerns on endowment spending for student aid, with little recognition that endowment spending on other operational areas relieves tuition pressure. Many fail to realize that covering institutional costs with endowment payouts eases the need to pay for necessary institutional expenses with tuition dollars or other revenue.

Also missing from recent discussions is the recognition that endowment managers are legally obligated to support current students and operations, while at the same time balancing asset management goals to ensure financial soundness for the institution in the future.

Endowed funds—at colleges, universities, and many other private 501(c)3 organizations—represent the institution's or organization's promise to donors to use income and investment gains generated by their gifts to support an aspect of the university's mission, usually in perpetuity. Colleges and universities, large and small, maintain endowments or other reserves that enable them to respond to unforeseen changes or seize new opportunities in pursuit of their respective missions.

Changes to Endowments in the Tax Cuts and Jobs Act

Following passage of the 2017 Tax Cuts and Jobs Act, private colleges and universities are now subject to a 1.4 percent excise tax on net investment income if they have at least 500 students, with more than 50 percent of those students located in the United States, and assets (other than those used directly in carrying out the institution's educational purposes) valued at the close of the preceding tax year of at least \$500,000 per full-time student.

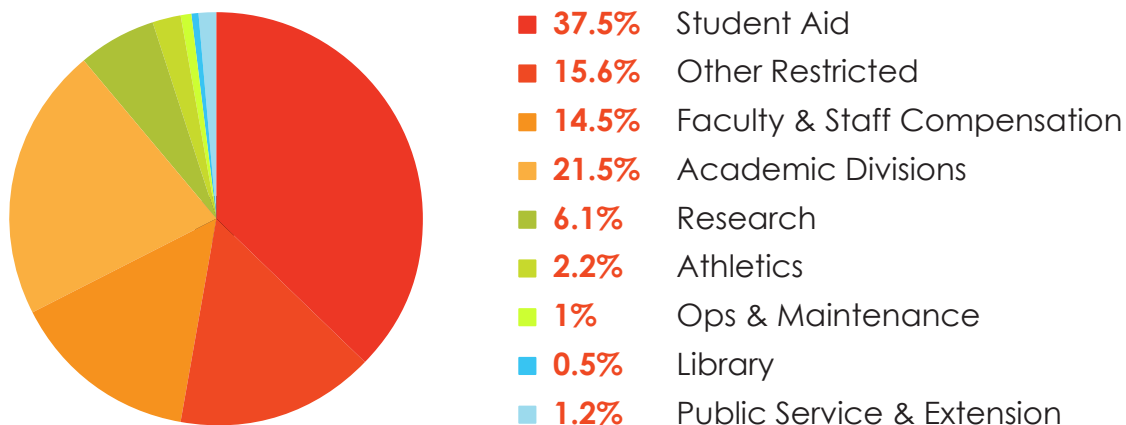
The Joint Committee on Taxation summary explains that “assets used directly in carrying out the institution's exempt purpose” include, for example, classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities and are excluded from the assets-per-full-time equivalent (FTE) calculation. Additionally, the number of students is based on the daily average number of full-time students, with part-time students being considered on an FTE basis. Further direction was given in the bill that the secretary of the Treasury should promulgate regulations to carry out the intent of the provision, including regulations that specify:

1. Assets that are used directly in carrying out the educational institution's exempt purpose;
2. The computation of net investment income;
3. Assets that are intended or available for the use or benefit of the educational institution.

Many lawmakers have since recognized that this tax will reduce dollars available for scholarships, student services, research, and campus operating expenses, and that it represents a departure from the federal government's commitment to philanthropic freedom—the right of Americans to choose how and where to spend their charitable assets. As a result, Reps. Bradley Byrne (R-AL) and John Delaney (D-MD) introduced H.R. 5220; this bill would repeal the endowment excise tax in its entirety.

Rep. Tom Reed (R-NY) continues to raise concerns about university endowments. He introduced H.R. 5916, which would impose new mandatory endowment payouts and harsh penalties on institutions for "undistributed required payouts." These penalties vary from levying additional taxes to eliminating the deductibility of donations to the endowment, and most harshly could call into question the tax-exempt status of an institution. The bill would also impose new reporting requirements on colleges and universities, cap the deductibility of restricted endowment gifts, and tax endowment distributions that aren't used strictly for scholarships.

Distribution of Restricted Endowment Gifts, 2017



**2017 Voluntary Support of Education Survey, Council for Aid to Education*
Percentage distribution of gifts to endowment with restrictions on the use of earned income

Institutions should consider these talking points when discussing endowments and charitable giving:

- Our foundation raises funds in excess of \$_____ per year to support the university's strategic priorities and manages an endowment of more than \$_____.
- Our most recent comprehensive fundraising campaign engaged more than _____ donors who made gifts exceeding \$_____ to advance our school's priorities.
- The annual endowment impact is significant and growing, totaling nearly \$_____ for the university this year and more than \$_____ in the past five years combined.
- Charitable giving is fueling our commitment to providing an affordable, quality education.
- Studies of charitable giving indicate that tax deductions are an important factor leading donors to make gifts. We ask Congress to remove the new barriers that may limit charitable giving.
- Endowments are critical for student financial aid (scholarships), but they also provide important funding sources for faculty, libraries, laboratories, student services, and other components that are key to a student's education.
- Endowments also support research and public service missions, such as innovations in nanotechnology, medical research, or university-based youth and community development programs.
- Endowments are an instrument of good financial planning for nonprofit entities—large and small. They are not a savings account or a rainy-day fund. They are managed to provide a steady, long-standing, reliable funding source over the long term.

- *The NACUBO-Commonfund Study (2016) of Endowments* shows that 74 percent of institutions increased dollar spending in 2016, and the median increase was 8.1 percent—despite overall negative returns for that year. This spending increase is attributable in large part to the way endowments are managed for the long term.

Also consider:

- Endowments are a collection of funds—often comprised of hundreds or even thousands of individual funds that range in size from less than \$10,000 to more than \$1 million—managed for both future needs and current needs.
- Most college and university endowment funds have a specific, donor-directed purpose (e.g., research, financial aid, public service).
- Endowed funds represent the school's promise to donors to use income and investment gains generated by their gift into perpetuity.
- Donors often stipulate the purpose for which funds can be spent and expect funds to last into perpetuity.
- An institution's governing board determines the appropriate spending distribution policy. Spending policies strive to balance two primary investment objectives:
 1. The need for current operating income.
 2. The need to preserve the endowment's future purchasing power.

TAX-EXEMPT BOND FINANCING

There are more than **3,300 public and nonprofit colleges and universities** in the U.S., which collectively educate nearly 19 million students, engage in more than \$67 billion in research and development, and contribute to a vast array of public service endeavors.

Public colleges and universities are typically a component of state or local governments, while private institutions are recognized as tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code. Tax-exempt bond financing available to public institutions is also referred to as **municipal bonds**; similar financing is currently available to nonprofit colleges and universities (and some public institutions) as qualified **501(c)(3) private activity bonds**. The nonprofit educational institution borrower, not the governmental body issuer, is solely responsible for and liable to repay the bonds.

Private nonprofit colleges and universities, just like their public counterparts, rely on these financial instruments to acquire, construct, renovate, and expand capital infrastructure, such as academic buildings, residence halls, modern energy plants, and more.

For colleges and universities, the interest rates on municipal bonds and private activity bonds are significantly lower than on taxable bonds, thus creating beneficial financial terms.

Indeed, the interest rate spread between taxable and tax-exempt bonds typically ranges between 150 and 200 basis points. The lower interest rates create significant savings by lowering the financing cost of multi-million-dollar construction projects, often financed over a 30-year period. The lower financing cost allows colleges and universities to keep tuition lower than would be the case if taxable financing was used.



For many institutions, revenue from tuition or from restricted gifts simply does not provide sufficient funds to build, expand, and renovate as is necessary to meet their respective missions, and taxable debt is costlier, often by a material amount. In fact, many smaller, lower or nonrated institutions would not be able to access the taxable market, which has much different purchasers. Banks would have much less interest in purchasing nonprofit education debt.

Changes to Tax-Exempt Bond Financing in the Tax Cuts and Jobs Act

Advance refunding bonds were effectively eliminated beginning after December 31, 2017, after passage of the Tax Cuts and Jobs Act. In the past, advance refunding, as a strategic finance tool for infrastructure spending, saved institutions thousands, and in some instances millions, of dollars. These bonds offered favorable rates by refinancing outstanding bonds that have not yet matured used for capital investments (e.g., renovation, construction of facilities).

Under the new law, interest earned by investors on advance refunding bonds (i.e., refunding bonds issued more than 90 days before the redemption of the refunded bonds) became taxable. (Interest on refunding bonds issued prior to the change will continue to be tax-exempt.) This change effectively eliminates the attractiveness of such bonds to investors, thereby eliminating any demand for them, and jettisoning 30 percent of the municipal bond market. Thus, this impacts any institution, public or private, that might wish to issue advance refunding bonds; the change in law materially limits their ability to lower debt cost or eliminate restrictive covenants.

Unrelated Business Income Tax (UBIT)

Nonprofit entities are subject to normal corporate tax rates on certain activities that generate revenue defined as “unrelated business income.” Whether an activity is subject to the unrelated business income tax (UBIT) is determined through a three-part test that asks: Is it a trade or business; is it regularly carried on; and is it substantially related to the exempt organization’s mission? There are also several categories of activities that, by statute, are not treated as unrelated business income.

Colleges and universities, whose primary missions are related to education, research, and community service, should pay taxes on unrelated business activities. However, new record keeping and reporting guidelines imposed on colleges and universities by the Tax Cuts and Jobs Act have resulted in disparate treatment for nonprofit organizations by holding them to standards and rules not applicable to corporations.

Changes to UBIT in the Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act requires colleges and universities to now calculate all gains and losses in unrelated business income separately, by activity, rather than in the aggregate. Institutions will no longer be able to offset all gains against all losses. This requirement, colloquially known as “**basketing**,” is not present in corporate taxation, even though higher education institutions incur unrelated business income taxation at the corporate rate. This requirement could result in a higher tax burden for many colleges and universities, and fewer resources for serving students.

New UBIT on Transportation Fringe Benefits

The Tax Cuts and Jobs Act made it costlier for tax-exempt entities to be employers by including a new provision that treats the transportation and parking benefits these institutions provide to employees as unrelated business income. Colleges and universities will now be taxed, at the corporate tax rate (21 percent), on the value of providing these benefits to employees.

Several lawmakers in the 115th congress introduced legislation to undo the impact of these changes.

Executive Compensation Excise Tax

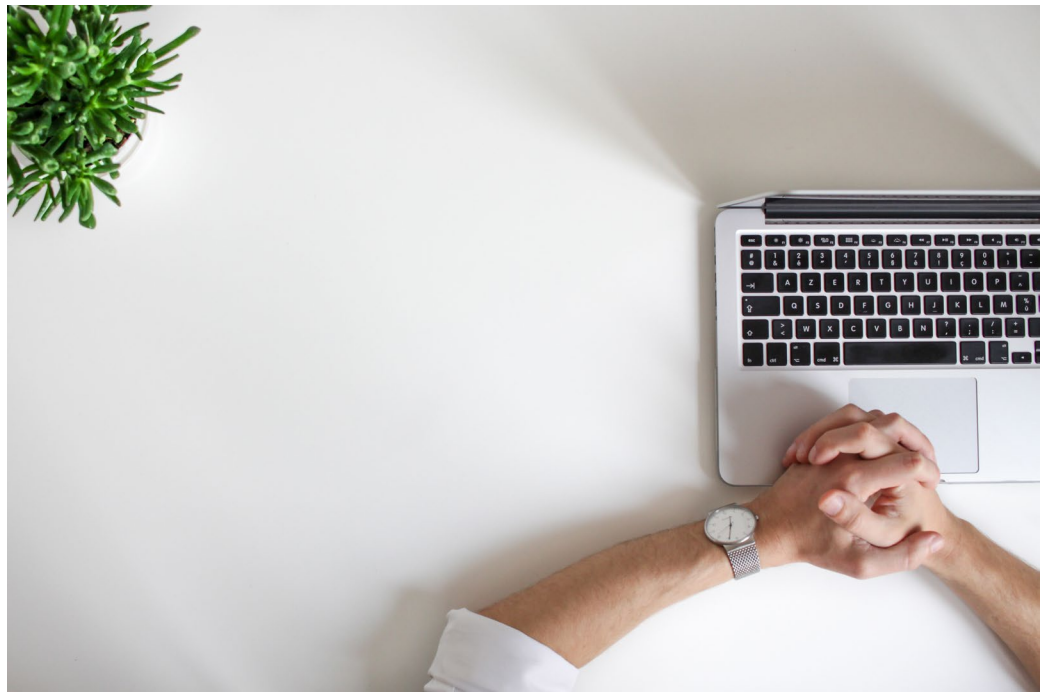
Compensation decisions at colleges and universities are made by board or committee members vetted for conflicts of interest. Exempt organizations, including private institutions, are required to adhere to a rigorous process prescribed by the IRS when setting executive compensation. That process enables organizations to attract the best talent while maintaining institutional integrity.

Changes to Executive Compensation in the Tax Cuts and Jobs Act

Colleges and universities are now subject to a 21 percent excise tax on compensation of \$1 million paid to any of its five highest-paid employees for the tax year. This tax is punitive and will increase costs for all affected organizations.

The tax applies to all vested remuneration paid to a covered individual for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan, and amounts that are excludable from the executive's gross income.

Once an employee qualifies as a covered person, the excise tax applies to compensation in excess of \$1 million paid to that person, for as long as the organization pays them remuneration. The excise tax also applies to excess parachute payments paid by the organization to such individuals. Under the provision, an excess parachute payment generally would be a payment contingent on the employee's separation from employment with an aggregate present value of three times the employee's base compensation or more. Exemptions to this requirement are made for compensation paid to employees who are not highly compensated employees (within the meaning of Section 414(q)) from the definition of parachute payment. The law also exempts compensation attributable to medical services of certain qualified medical professionals (doctor, nurse, or veterinarian) from the definitions of remuneration and parachute payment.



Section 127

Not only do institutions of higher education prepare tomorrow's workforce, but they must also attract qualified employees and maintain skilled workforces of their own. Some early proposals in drafts of the Tax Cuts and Jobs Act before its final passage sought to severely limit this ability of both higher education institutions and employers in all other sectors by eliminating employer-provided tax-exempt tuition assistance.

Section 127 allows employers to offer employees up to \$5,250 annually in tuition assistance, which is excluded from taxable income. Employers are never required to provide assistance under Section 127. This benefit must be offered to all employees on a non-discriminatory basis to ensure that the benefit does not favor the highly compensated.

When it was enacted as an expiring tax benefit in 1978, Section 127 was intended to allow employers to completely cover the cost of higher education. Unfortunately, the benefit amount of \$5,250 annually has not been increased in almost 40 years.

The benefits offered by Section 127 are a valuable tool for employers to attract the best possible employees and build a skilled workforce. Section 127 helps support U.S. competitiveness and could, if strengthened, become the benefit of choice for tuition assistance and loan repayments among employers.

Changes to Section 127 in the Tax Cuts and Jobs Act

While early versions of the Tax Cuts and Jobs Act threatened to eliminate Section 127, those proposals were ultimately rejected; the provision remains intact and unchanged by the final bill.

Fortunately, several lawmakers have recognized the importance of Section 127 to U.S. employers and have introduced the proposals below to expand on the existing benefit and proposed in the 115th Congress:

H.R. 795: Introduced by Rep. Rodney Davis (R-IL) and would expand Section 127 by including loan repayment as an allowable employer-provided benefit.

H.R. 4135: Introduced by Rep. Jason Smith (R-MO) and would increase the allowable employer-provided benefit amount under Section 127 from \$5,250 to \$11,500.

NACUBO is a member of the **Coalition to Preserve Employer Provided Education Assistance**, a broad-based collection of groups representing business, labor, and education dedicated to preserving and expanding Section 127 of the Internal Revenue Code to include student loan repayment and to raise the yearly allowed limit.

Section 117(d)

Section 117(d) permits educational institutions, both secondary and postsecondary, to provide employees and their spouses or dependents with tuition reductions that are excluded from taxable income.

If an institution chooses to offer this benefit, then all employees must be able to receive it. As a result, Section 117(d) provides a particularly important benefit to many middle- and low-income college employees. In fact, most employees benefiting from the provision are low- and middle-income.

According to a 2017 survey of nearly 300 institutions by the College and University Professional Association for Human Resources, 50 percent of employees receiving tuition reductions for themselves or family members earned \$50,000 or less, and 78 percent earned \$75,000 or less.

In addition, Section 117(d) gives colleges and universities a crucial tool for recruiting and retaining valued employees, which is particularly important for many small, private schools in their efforts to attract and compete for top employees.

Section 117(d)(5) reduces the cost of graduate education and mitigates the tax liability of graduate students engaged in teaching and/or research as part of their academic programs. Without this provision, thousands of graduate students would be subjected to either a major tax increase or a significant increase in tuition as universities would be forced to curtail tuition reductions. This would likely lead to increased student debt as many of these students might consider borrowing to pay these taxes or their tuition bills.

Section 117(d) Left Unchanged in the Tax Cuts and Jobs Act

While early versions of the Tax Cuts and Jobs Act threatened to eliminate Section 117(d), those proposals were ultimately rejected, and the provision remains intact and unchanged by the final bill.



American Opportunity Tax Credit & Lifetime Learning Credit

NACUBO has supported simplification of the current system of education incentive tax credits through the creation of a single, permanent tax credit with automatic inflation adjustments, making it easier to use and more effective. A single, permanent, refundable credit, available beyond the first four years of college and to both full-time and part-time learners, would negate the need for the separate higher education provisions, which currently include the American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit (LLC).

The AOTC is a federal tax credit for qualified expenses paid for eligible students for the first four years of higher education. The maximum annual credit is \$2,500 per student and it is refundable, meaning if the credit brings the amount of tax a student owes to zero, the student can have 40 percent of any remaining amount of the credit—up to \$1,000—refunded.

The LLC is also a credit for qualified tuition and related expenses paid for higher education and is available not only to undergraduate courses, but also graduate and professional degree courses, including those to acquire or improve job skills. There is no limit on the number of years a student can claim the credit, and it is worth up to \$2,000 annually per student. The LLC is not a refundable tax credit.

Proposed Changes to AOTC and LLC in the Tax Cuts and Jobs Act

While early versions of the Tax Cuts and Jobs Act proposed condensing the AOTC and LLC into one credit by eliminating Lifetime Learning and adding an additional year of AOTC eligibility, this proposal was ultimately rejected and both credits remain unchanged.

Student Loan Interest Deduction

The student loan interest deduction allows certain individuals to deduct up to \$2,500 in student loan interest, with a phase-out for certain taxpayers. Recent federal actions have increased the borrowing costs for students and recent graduates by implementing interest charges for graduate students while they are in school and by eliminating the six-month interest-free grace period that college graduates have traditionally received. In 2014, 12 million taxpayers benefited from the student loan interest deduction.

Proposed Changes to the Student Loan Interest Deduction in the Tax Cuts and Jobs Act

While early versions of the Tax Cuts and Jobs Act threatened to eliminate the Student Loan Interest Deduction, that proposal was ultimately rejected, and the deduction remains intact and unchanged by the final bill.

Also of Note

Pressure on State Budgets

The Tax Cuts and Jobs Act has limited itemized deductions for all state and local taxes (i.e., property taxes, income taxes, or sales tax in lieu of income tax) to \$10,000. This cap is widely expected to have negative impacts on state budgets, as state lawmakers will be forced to make budget cuts accordingly. State-level support for public education has dramatically declined since the Great Recession and this further pressure on state government budgets will undoubtedly result in more cuts to higher education funding.

Some states have sought work-arounds to this, attempting to create pathways for taxpayers to make charitable contributions to municipal governments in lieu of tax payments. However, the state and local taxes deduction cap avoidance measures are seen by many in Washington as questionable policies and it is likely the IRS, Treasury, and/or Congress will take action to limit these work-arounds.

NACUBO'S VALUE OF HIGHER EDUCATION INITIATIVE

According to the College Board's "Education Pays 2016," college graduates in 2015 earned markedly more than high school graduates:

- Median annual earnings, college graduates: \$61,400
- Median annual earnings, high school graduates: \$36,800

Further, college graduates earn a median of \$1 million more over the course of their lives than those with only a high school diploma—\$2.3 million in lifetime earnings versus \$1.3 million, according to the Georgetown Center on Education and the Workforce report, "The College Payoff," 2014.

College graduates are also much more likely to be employed than high school graduates; recent data from the National Center for Education Statistics show that even for students who graduated into the Great Recession,

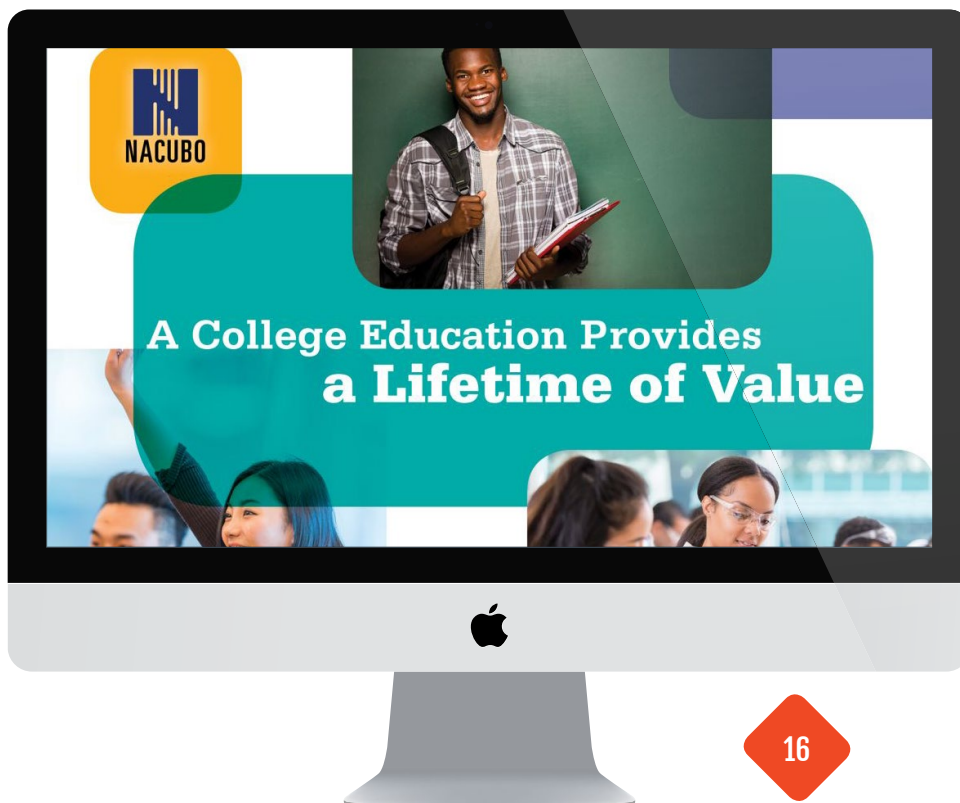
their college degrees helped them to fare better in the economy than those with no higher education.

While it is tempting to see these numbers and reflect upon them only as a private good, greater earnings and lower unemployment rates reflect increased productivity of the economic system overall. College-going benefits society in other ways as well, the College Board research shows. College graduates are more likely to vote in elections and give back to their communities. They are also more likely to lead healthy lifestyles—exercising more, smoking less—and enjoy longer life spans, on average, than their counterparts who earned only a high school diploma.

The federal tax code has long recognized the value of education as public good, not only in preventing or relieving poverty and adverse social conditions for individuals, but also in advancing knowledge and research

for society at large, and fostering the productive and civic capacities of citizens, which is fundamental to our democratic society.

Teaching, research, and public service have been recognized in federal law as critical to the well-being of our democratic society. Higher education institutions are in turn exempted from income tax so they can make the most of their revenues. Colleges and universities can use more resources than would otherwise be



available to fund academic programs, student financial aid, research, public extension activities, and their overall operations. As nonprofits, they are uniquely different from corporations that pay out profits to executives and shareholders and they are accountable to donors and trustees that operate as fiduciaries. Public colleges are further governed by state government oversight.

The many provisions of the Tax Cuts and Jobs Act that erode the tax-exempt status of higher education institutions make it clear that the time has come for colleges and universities to better tell their own stories. Provisions in the Tax Cuts and Jobs Act make it harder, not easier, for schools to contribute to strengthening the U.S. economy, advance cutting-edge research, promote the general good, and educate the workforce of tomorrow.

NACUBO urges all institutions, public and private, small and large, to prevent any further erosion of support.

NACUBO launched the Value of Higher Education Initiative in 2017, which aims to counter this negative discourse surrounding higher education's value proposition, promote its myriad benefits, and shape public opinion toward a more positive perception of its contributions. Legislators need to hear from colleges and universities at home—in real and simple terms—the value of campuses to their states and communities. To better serve students and higher education, your representatives in Congress need to know your institution's story. As campus leaders, business officers should play a key role in building your school's message.

We hope that the tools, fact sheets, and communication materials, [available here](#), will assist you in articulating the value of higher education within your own community.