Congressional Research Service

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Congressional Research Service
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The Committee on Finance
United States Senate
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on
Offshore Tax Issues

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss investments of educational institution endowments and off-shore funds.[1] At issue is the use of offshore feeder corporations that allow tax exempt investors, including educational institutions, to avoid the unrelated business income tax. Although I discuss the consequences of options and approaches, please note that the Congressional Research Service takes no position on legislative options.

Educational institutions have significant endowments, totaling at least $340 billion in 2006; these endowments have been growing rapidly, and earn a relatively high rate of return. Their overall return of 15.3% in 2006 translates to earnings of $52 billion, earnings that are generally tax exempt. Forgone revenue from not taxing that income at a 35% rate is larger than the total tax expenditure for charitable giving to education.

Endowment assets are not evenly distributed among higher education institutions: Harvard, with the largest endowment, had 8.5% of the total, the top five institutions ranked by endowment had 25%, the top 20 almost half, and the 62 institutions with over $1 billion in assets account for two thirds.

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[1] Data reported in this testimony, unless otherwise specified, are taken from a CRS Memorandum prepared for Senator Baucus and Senator Grassley, by Jane G. Gravelle, August 20, 2007, which is referenced here with their permission. Those sources in turn included National Association of College and University and Business Offices, 2006 (NACUBO) Endowment Study, [http://www.nacubo.org/x2376.xml]; *The Chronicle of Higher Education; The Chronicle of Philanthropy: Endowments at Non-Profits Organizations, Year Ending June 30, 2005*; John Hechinger, "When $26 Billion is Not Enough," *Wall Street Journal*, Dec. 17, 2005; U.S. Department of Education, National Center for Educational Statistics, College Opportunities Online Locator [http://nces.ed.gov/ipeds/cool/index.aspx]; Lynne Munson, "Robbing the Rich to Give to the Richest," *Inside Higher Ed*, July 26, 2007, at [insidehighered.com] and various annual reports.

Educational institutions' endowments have a significant and growing share of their portfolios in hedge funds and private equities, which are likely to be heavily invested in offshore funds. Overall, weighted by institution (the institutions share's are averaged), 22% of endowment portfolios in 2006 were in these hedge fund and private equities investments, up from 14% in 2002. The share would be much larger if the percentage were weighted by endowment size because larger funds have larger shares. Funds over a billion dollars have 28% in these funds (averaged across institutions), and the total percentage weighted by assets would presumably be larger. It is difficult to obtain data on an institution by institution basis, but of the top ten funds, in 2005 Columbia University had a 45% share, while Princeton and Yale had 38% and 37% respectively. The most heavily endowed four year liberal arts colleges also had significant shares (where data were available): two of the top seven, Amherst and Smith, had shares over 40% and two, Grinnell and Williams, had shares over 30%.

Data on the share in offshore investments is not available but one study indicated that Duke University had 75% of their hedge funds in offshore investments.[2]

Two possible revisions of current treatment to prevent tax exempt educational institutions from avoiding the unrelated business income taxes by investing in offshore funds are often discussed. The first would be to restrict the use of offshore investments, which would lead to additional taxes collected. It could also cause a shift in investments.[3]

An alternative approach would be to leave the current treatment of these institutions' investments in place but address whether these institutions should be doing more, or be required to do more, with their endowments to pursue objectives for the public good, such as making education more affordable, given the tax advantages granted. Indeed, when questioned by a reporter about the use of offshore entities, a spokesman for Duke University stressed the use of endowments for financial aid and research.[4] The remainder of this discussion addresses how the tax-preferred earnings from endowments are used and what approaches might be considered to direct these resources to objectives such as more affordable tuition.

Endowments are currently earning high returns, with most of that return being used to increase the endowment rather than being spent. While the average return in 2006 was 15.3% the payout rate was 4.6%, weighted by institution. Educational institutions with large endowments earned the highest returns on average; payout rates were about the same across institutions with different endowment sizes. Again, while it is difficult to obtain institution level data, the three institutions with the largest endowments, Harvard, Yale, and Stanford, earned returns of around 20% (in 2004-2005) but paid out 4.5% (in 2003-2004). Out of the ten institutions with the largest endowments, only three paid out more than 5%, and out of eight private institutions, only one paid out more. Out of the top twenty, only five paid out more than 5%. Over the two year period Harvard's endowment grew by 30%, while Yale's

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[2] Maximilian M. Haag, "Hedge Fund Investments of Private Foundations and Educational Endowments," *Tax Notes Today*, November 15, 2005.

[3] Economic theory suggests that there would be some shift out of investments, but the magnitude is uncertain. At least one expert, Leon Metzger, is quoted as saying that a major impact is unlikely. See Stephanie Strom, "Nonprofits Face Threat to a Tax Loophole," *New York Times*, May 16. 2007.

[4] Stephanie Strom, "Nonprofits Face Threat to a Tax Loophole."

and Stanford's grew by 40%. All of the endowments of private institutions in the top ten grew by at least 20%.

While the top ten four-year liberal arts colleges had lower returns, most of them also had relatively low payout rates relative to returns, and significant growth in their endowments.

Institutions indicate that they limit payout rates in part to cushion shocks. This is a standard practice to account for years of losses. However, despite covering a recession with significant market losses, returns remained, on average, well above payout rates over the past five and ten years. Many institutions with large endowments have very high endowments per student. Per undergraduate student, Harvard, Yale and Princeton have between $2 and $3 million; per total student they have between $1 and $2 million. MIT, Stanford and Rice have endowments per undergraduate exceeding $1 million and endowments per student exceeding $500,000. All of the private institutions in the top 20 have endowments per student well over $100,000.

The ten liberal arts colleges had large endowments per capita as well: seven of the ten had over $500,000 and the remaining three around $100,000.

If an approach to addressing the offshore shelter issue is to permit tax benefits but to target them towards making tuition more affordable, an issue to consider is the size of endowments relative to tuition increases and financial aid. While endowments were growing, these institutions with large endowments continued to raise tuition in most cases by 5% or more. If Harvard, Yale, Princeton, MIT or Stanford had paid out 1/10 of 1% of their endowment for undergraduate tuition, undergraduate tuition increases would have been unnecessary to maintain the budget. In none of the 20 institutions with the largest endowments were tuition increases larger than 7/10 of a percent of the endowment, so that all of these institutions could have avoided undergraduate tuition increases by increasing their payout ratio by less than one percentage point. Similar magnitudes applied to the ten liberal arts colleges (although Berea is an essentially tuition free college). Of the 62 institutions with over a billion dollars in endowments, their 6.8% tuition increase averaged 9/10 of 1% of the endowment.[5]

Harvard's institutional undergraduate aid was less than ½ of a percent of the endowment, so that by paying out an additional ½ of a percent, they could have doubled aid. The same is true of Stanford and Princeton, while Yale's undergraduate aid was 1/3 of 1% of the endowment. Many other schools in the top 20, especially private schools could have significantly increased their undergraduate aid with a small additional payout from the endowment, while still permitting endowments to grow well in excess of real growth. Out of the ten liberal arts colleges, six had institutional aid of less than 2% of endowment, and could have significantly increased their aid with a small increase in payout. For the 62 institutions with over $1 billion in endowments, total aid was 2.85% of total endowments.

In general, therefore, it appears that the main effect of the high returns on endowments, for those institutions with large endowments, is to increase the size of the endowment.

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[5] Note that some donations have provisions directing the use of funds for specific purposes, such as stadiums and professorships.

There are a number of policy options that might be alternatives to a restriction of these offshore investments by educational institutions. Private foundations are required to pay out a portion of their assets, and are subject to a minimum rate of 5%, which leads to an average payout of 7%. The overall payout ratio on educational institutions' endowments fall below this level. One option would be to require a payout rate; or to require a payout rate (or a higher rate) for institutions as long as their per student endowment is above a fixed amount. Alternatively, one could relate the payout rate to the earnings rate so as to preserve the real value of the endowment and perhaps some small growth, but not allow it to grow so rapidly. Another option, if the public policy concern is about affordable education, would be to impose a tax on the endowment for schools with tuition increases over a pre-determined threshold.