

Tax Arbitrage by Colleges and Universities

Colleges and universities enjoy a variety of federal tax preferences that are designed to support a broader public purpose—the advancement of higher education and research. Not only are institutions of higher learning exempt from paying federal income taxes, they also are eligible to receive tax-deductible charitable contributions and allowed to use tax-exempt debt to finance capital expenditures.

This Congressional Budget Office (CBO) study focuses on one of those tax advantages, the ability of colleges and universities to borrow funds by issuing tax-exempt debt. According to the staff of the Joint Committee on Taxation, the cost of allowing institutions of higher learning to borrow using such debt—measured in terms of the revenues that could have been collected if those institutions had borrowed using taxable debt—will be about \$5.5 billion in 2010. The use of proceeds from lower-cost tax-exempt bonds to directly finance the purchase of higher-yield securities—a practice known as tax arbitrage—is prohibited by law. Nevertheless, the law as currently implemented allows many colleges and universities to use tax-exempt debt to finance investments in operating assets (buildings and equipment) while, at the same time, they hold investment assets that earn a higher return. (Investment assets are publicly traded and privately held securities, as well as land or buildings held for investment purposes.) To the extent that colleges and universities can earn untaxed returns on investments that are higher than the interest they pay on tax-exempt debt, they are benefiting from a form of “indirect” tax arbitrage.

Rules in the Internal Revenue Code and regulations established by the Department of the Treasury limit tax arbitrage by restricting the yield on any investments held by the bond issuer that are deemed to be directly related to the tax-exempt bond issue (for example, an asset pledged as collateral).¹ Other investment assets are not yield-restricted even though they contribute indirectly to securing the bonds and are considered by rating agencies when rating the tax-

exempt debt. A broader definition of tax arbitrage would include most or all investment assets held by an institution borrowing with tax-exempt debt.

Using data from information returns filed with the Internal Revenue Service by institutions of higher learning and by issuers of tax-exempt debt, CBO developed measures of tax arbitrage as practiced by colleges and universities under a broader definition of the term that encompasses both direct and indirect tax arbitrage. Under one such definition, nearly all of the tax-exempt bonds that 251 institutions issued in 2003 would be classified as earning profits from tax arbitrage. If some investment assets were set aside in a reserve, which would be excluded from the arbitrage measure under an alternative expanded definition, the amount of debt earning returns from arbitrage would be lower; even so, about 75 percent of bonds issued in 2003 would still be classified as earning arbitrage profits under that expanded definition. By either measure, the amount of debt issued by colleges and universities that earns arbitrage profit would be considerably larger than that issued by nonprofit hospitals (which was the subject of a previous CBO study on broadening the definition of tax arbitrage).² Over time, if legislators were to expand the definition of tax arbitrage and thereby eliminate some of the benefits of tax-exempt financing, nonprofit institutions would probably respond by reducing the issuance of tax-exempt debt. That response, in turn, would decrease the cost to the federal government of the tax preference.

1. Internal Revenue Code, 26 U.S.C. 148(b)(3)(A). The terms “debt” and “bond” are used interchangeably to refer to debt with maturities in excess of a year. The dollar figures for such debt cited in this analysis also include any leasing arrangements that are tax-exempt.
2. Congressional Budget Office, *Nonprofit Hospitals and Tax Arbitrage*, letter to the Honorable William M. Thomas (December 6, 2006).