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EDUCATION

Which Colleges Will Have to Pay Taxes on Their Endowment? Your Guess Might Not Be Right

Small liberal arts colleges could take a hit from a new tax on investments, while some wealthy universities will avoid payments in the near-term

A Julliard student orchestra rehearses in March 2017 for a coming performance. The New York magnet school is preparing to pay a 1.4% tax on income from its $1 billion endowment. PHOTO: BESS ADLER FOR THE WALL STREET JOURNAL

By Richard Rubin and Andrea Fuller

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The Juilliard School, New York's magnet for aspiring artists, is bracing for a 1.4% tax on income from its $1 billion endowment. Three miles away, Columbia University and its $10 billion endowment will remain untouched for now.

A college-endowment tax, enacted in December in the Tax Cuts and Jobs Act signed by President Donald Trump, is causing confusion and frustration at schools across the country, which rely on the previously tax free-earnings when setting their budgets.

Small liberal arts colleges will likely be hit disproportionately because many have sizable endowments but limited enrollment. The tax applies only to private schools with at least 500 students and at least $500,000 of investments per student.

The change was driven by congressional Republicans, who say colleges building up large, tax-favored endowments should use more of that money to reduce tuition and support low-income students.

The criteria were meant to ensure that universities with the largest endowments, including Harvard University, Yale University and Stanford University, will pay the tax. The investment-per-student threshold was raised to $500,000 in the final tax bill after colleges complained to their representatives about a lower cutoff included in earlier versions. The tax will raise $1.8 billion over a decade, according to the Joint Committee on Taxation.

Schools have continued to protest the move, saying they often use endowment earnings to provide financial aid and warning that diverting funds to pay the new tax will only make it harder to do what GOP lawmakers want.

The Cooper Union for the Advancement of Science and Art in New York hopes to eventually resume letting students attend without paying tuition, a century-old tradition it abandoned under financial stress in 2014. The college, which expects to pay the tax, currently covers half-tuition for all undergraduates.

"The new tax-reform plan has the potential to make that return to free tuition much more difficult," said President Laura Sparks in a statement.

Although it still isn't clear exactly how the endowment tax will be calculated, the provision appears to create a system of winners and losers that could alter how schools grow, invest and spend.

The wealthiest schools, such as Harvard and Princeton University, will definitely pay, while the smallest and least wealthy schools won't.

Some wealthy universities will probably avoid the tax in the near-term. Columbia, New York University, the University of Southern California, Vanderbilt University and Johns Hopkins University all have endowments over $3 billion. But their endowments fall below the $500,000-per-student threshold because they have so many students, federal data show.

Columbia's endowment, for example, was worth about $326,000 per student at the end of 2016. The university has about 9,000 undergraduates and more than 23,000 graduate and professional students.

But small liberal arts colleges like Claremont McKenna College, in Claremont, Calif., Berea College, in Berea, Ky., and Bowdoin College in Brunswick, Maine—all with endowments of about $1.5 billion or less—are likely to pay.

With the $500,000 figure fixed, more schools are expected to be included in future years.

Hamilton College, in Clinton, N.Y., where the endowment just hit $1 billion, is likely to just surpass the $500,000 endowment-per-student threshold, the school says. That will trigger a tax bill of about $500,000, out of a $180 million annual budget.

The tax includes no brackets, making it an all-or-nothing proposition for schools on the cusp. That could push colleges like Hamilton, with about 1,865 students, to consider increasing enrollment to stay under that $500,000 threshold.

"The most logical thing is to look at enrollment," said Karen Leach, Hamilton's vice president for administration and finance. "But there's other things to consider. I don't have any housing to put them in."

Meanwhile, schools that meet the $500,000-per-student endowment threshold but have fewer than 500 students will be penalized if they add too many students.

Principia College, a liberal arts college in Elsah, Ill., has about 440 students this year, and President Jonathan Palmer said hitting 500 students would trigger a tax of between $500,000 and $600,000.

"We feel that we have room for more students," Mr. Palmer said. "As we get closer to that 500 number, it's a challenge to say, 'Is that student worth $600,000?' "

Until the IRS and the Treasury Department provide guidance, it remains uncertain which investment assets will be taxed. The agencies are expected to define the "assets which are used directly in carrying out the institution's exempt purpose," which the law exempts from being used to calculate endowment size.

"We would argue that there's nothing that we generate that's not used to carry out the institution's educational purposes," said Stephen Briggs, president of Berry College in northwest Georgia, which expects to pay the tax in the near future.

Even if schools can't stay out of the tax, they will have incentives to minimize their annual investment income and thus their tax bill. That could mean waiting to realize gains, harvesting losses and engaging in other behavior that tax-exempt institutions don't always concern themselves with.

"One thing that we should probably expect to see is for colleges and universities to act more like other taxpayers," said Brian Galle, a tax law professor at Georgetown University.

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Republicans say the tax mirrors a levy on private foundations and puts colleges on notice that Congress is watching how they use funds subsidized with charitable deductions and tax exemptions.

"The goal is pretty simple: It encourages colleges to use their major endowments to lower the cost of education," said Rep. Kevin Brady (R., Texas), chairman of the House Ways and Means Committee.

But as written, the law doesn't directly reward colleges for lowering costs, reducing tuition or providing more financial aid—unless they spend down their endowment below the $500,000 per student threshold.

Rep. Tom Reed (R., N.Y.), said Congress could use future legislation to dangle new incentives before schools. The government, he said, could "suspend this tax so long as your returns on your investments are going to tuition reduction for working families" and there is disclosure about spending.

For now, schools are preparing to pay. Alexandra Day, a Juilliard spokeswoman, said the school's tax liability could be between $500,000 and $1.5 million.

"Much of our endowment portfolio supports scholarships for our students and other key elements of the School's educational and performing arts programs," she wrote in an email. "So any tax that we pay will impact the availability of funds to award for that purpose."

Dean Zerbe, a former aide to Sen. Chuck Grassley (R., Iowa), disputed that the tax would hamper schools' ability to offer financial aid—a subject he said he studied extensively while working for the senator.

Colleges, he said, "have more than enough flexibility from donors to do more for low-income students."

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