

Client Alert

Latham & Watkins Tax and Finance Departments
Tax-Exempt Organizations

Federal Focus on Indirect Tax Arbitrage Benefits to Colleges and Universities: Could Access to Tax-exempt Bonds be Limited?

Tax arbitrage, the use of tax-exempt bond proceeds to purchase higher-yield investment assets, is generally prohibited under federal law. Recently, the United States Congressional Budget Office (the CBO), expressed concern that, under certain circumstances, tax-exempt colleges and universities may enjoy indirect tax arbitrage benefits by using tax-exempt bond proceeds for the purchase/construction of operating assets while simultaneously holding and investing endowment assets at a higher rate of return. In the CBO's view, the untaxed return on such investments, to the extent it exceeds the interest payments on a college or university's tax-exempt debt, may be viewed as an indirect tax arbitrage benefit.

A recently issued CBO study¹ examines this "indirect" tax arbitrage and the potential increase in federal tax revenue that could result from additional legal restrictions in this area.

Current Tax Arbitrage Rules

The Internal Revenue Code (the Code) seeks to prevent the direct diversion of tax-exempt bond proceeds from investments in designated capital projects into investments generating investment income.² There are limited exceptions to these rules that permit

the temporary investment of funds during periods prior to the use of bond proceeds or for specific types of investments such as reserve funds (*e.g.*, debt service reserve funds). Outside of these exceptions, however, any tax arbitrage earnings are generally required to be deposited in a rebate fund and delivered to the United States Treasury (the Treasury). The Treasury uses a "replacement proceeds rule" to expand coverage of the tax arbitrage rules to apply to any investment assets or other amounts that have a connection to a tax-exempt bond issue that is sufficiently direct that, in the absence of proceeds from tax-exempt borrowing, the assets or amounts would have been used to finance the project.³

Lack of Coverage for Indirect Tax Arbitrage Gains Under Current Tax Arbitrage Rules

The replacement proceeds rule is difficult to enforce where financial statements do not report use of certain assets as collateral, and the rule does not cover assets that are not specifically pledged to pay debt service or have no other connection to a tax-exempt bond issue, even if the return on those assets is used to pay interest on tax-exempt debt. Certain college and university

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endowment funds earning interest at higher yields could be used to pay tax-exempt interest even if the source of those payments is not specifically disclosed to the Internal Revenue Service (the IRS). According to the CBO, this situation creates the potential for indirect tax arbitrage. The CBO goes on to suggest that:

"[A] change in the rules that broadened the definition of tax arbitrage would identify bonds earning arbitrage profits on the basis of the total assets that were implicitly available as collateral rather than requiring a direct relationship between proceeds from tax-exempt bonds and investment assets explicitly pledged as collateral. That expanded definition, which would encompass indirect tax arbitrage, would decrease the value of the federal subsidy that is currently available to institutions of higher learning through tax-exempt-bond issues and reduce the net cost of the tax exemption to the federal government."⁴

In connection with its study, the CBO conducted an analysis using data from information returns filed with the IRS by colleges and universities and by issuers of tax-exempt debt, and developed measures of the tax arbitrage gains such institutions enjoyed in 2003.⁵ Those schools that borrowed using tax-exempt debt in 2003 also generally had investment assets that greatly exceeded their tax-exempt debt. Moreover, as a group, institutions with the largest share of investment assets had issued a substantial share of the tax-exempt bonds.⁶ Based on such findings, the CBO concluded that:

"The majority of outstanding tax-exempt bonds were held by schools with substantial investment assets, which would probably allow them to borrow even if tax-exempt borrowing was not an option. This suggests

that, as currently implemented, the subsidy is not used primarily to ease access to financial markets for schools that would otherwise have difficulty undertaking capital projects."⁷

CBO's Possible Approaches to Expanding Tax Arbitrage Definition and Institutional Response

While the CBO acknowledges the rationale for excluding certain investment assets from the reach of the tax arbitrage rules (*e.g.*, investment assets accumulated in order to establish operating reserves and protect against uncertainty, to obtain a stronger credit rating or to honor gift restrictions), it examines a variety of potential ways to expand the definition of tax arbitrage in order to eliminate what it views as indirect tax arbitrage. Among the alternatives identified by the CBO are:

- A requirement that earnings on restricted gifts be rebated if they exceed the interest paid on a tax-exempt bond
- A requirement that only certain investment assets, equal in value to one year's operating expenses, be set aside in a reserve that would be excluded from the tax arbitrage requirements, leaving the remainder of investment assets subject to tax arbitrage calculations and rebate

Colleges and universities may wish to pay increased attention to potential legislative responses to the CBO's study. An expanded definition of tax arbitrage would make tax-exempt borrowing a less attractive financing option, which could necessitate a reduction in capital spending, the replacement of tax-exempt debt with taxable debt or alternative forms of tax-exempt debt or the disposition of capital assets to finance new capital projects.

Endnotes

- ¹ Congressional Budget Office, *Tax Arbitrage by Colleges and Universities*, April 2010.
- ² Code § 148; Treas. Reg. § 1.148-2.
- ³ Treas. Reg. § 1.148-1(c). An example of such replacement proceeds is securities used as collateral for debt service obligations on a tax-exempt bond issue. Such securities would be subject to yield restriction as replacement proceeds.
- ⁴ *Tax Arbitrage by Colleges and Universities*, at p. 7.
- ⁵ Data from more recent years are now available, but the most current data available at the time the CBO undertook its analysis were for 2003.
- ⁶ The subset of schools that borrowed in 2003 had total investment assets approximating \$150 billion, nine times larger than the total reported outstanding tax-exempt bond debt; the median school that borrowed in 2003 had an estimated \$39 million in investment assets and \$22 million in tax-exempt debt. The top 10 schools that borrowed in 2003, ranked by investment assets, accounted for approximately 40% of the outstanding value of the tax-exempt bond debt, and the top 50 schools accounted for approximately 75% of the outstanding value of the tax-exempt bond debt. See *Tax Arbitrage by Colleges and Universities*, at p. 9-10.
- ⁷ *Id.* at p. 10.

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