No Need for Tax-Exempt Debt as Colleges Avoid IRS: Muni Credit
By Michael McDonald
June 25, 2012

More than a decade after nonprofits fought to end a cap on their sale of tax-free bonds, institutions from Columbia University to the University of Notre Dame are finding they can get a better deal by selling taxable securities after all.

Dartmouth College this month borrowed $150 million for 30 years at 3.76 percent, less than a half percentage point more than it would have paid in the municipal market. Photographer: Scott Eells/Bloomberg

While they pay more in interest, an increasing number of schools are finding it’s worth it to avoid the Internal Revenue Service, which limits what can be done with facilities financed through tax-exempt borrowing. The IRS has been stepping up enforcement at the same time many institutions want more flexibility to make money from research and other ventures as they face reduced government support.

“The regulations for tax exempts have become much more onerous and rates are right on top of each other,” said John Sejdinaj, vice president for finance at Notre Dame in South Bend, Indiana, which sold $100 million in taxable bonds last month. “We just give ourselves maximum flexibility.”

There have been more than a dozen deals this year, totaling about $3 billion, with more on the way as Bowdoin College in Brunswick, Maine, and the University of North Carolina prepare offerings, data compiled by Bloomberg show. For all of 2011, there were at least a half-dozen totaling about $2 billion, including $750 million of 100-year bonds from the Massachusetts Institute of Technology.

Federal Deficit

The borrowing decisions may have political ramifications. With the federal government facing a $1.2 trillion deficit and the exemption of municipal securities costing the U.S. Treasury about $30 billion a year, lawmakers may see an opening to try to limit the amount of tax-free bonds nonprofits can sell. That is what legislators did in 1986, capping the amount at $150 million for colleges and hospitals, a restriction that was later lifted.

“It could come back to bite them,” said Alan Schankel, head of fixed-income research and strategy at Janney Montgomery Scott LLC, an investment bank in Philadelphia. “After the election when Congress looks at tax reform, one of the arguments they’re going to use is: Look at all these university bonds that are issued with no subsidy.”

The issuance surge has come as Treasuries led a U.S. fixed-income rally amid Europe’s sovereign debt crisis, pushing municipal and corporate yields close to historic lows.

Narrowing Difference
The extra yield on taxable securities over tax-exempts has narrowed, said Eric Wild, a managing director in the public finance group in New York at Morgan Stanley, an underwriter of some of the deals.

The yield on top-rated, 30-year munis touched a record low of 3.47 percent this month, according to a Bloomberg index starting in 1991. The interest rate for corporate debt rated AA and maturing in more than 10 years fell to 3.79 percent, the lowest since 1973, a Barclays Plc index shows.

The difference between the two indexes slimmed to 0.3 percentage point this month from 1.09 points in January, and is less than a quarter of its average since 1993.

Dartmouth College this month borrowed $150 million for 30 years at 3.76 percent, less than a half percentage point more than it would have paid in the municipal market.

“There’s such a demand for this asset class because they continue to perform so well,” said John Augustine, an investment banker in New York at Barclays, another of the leading underwriters. “As universities think more and more about their balance sheets and the long-term horizon, taxable debt gives them real flexibility.”

Credit Crisis

Clifford Gannett, director of tax-exempt bonds at the IRS in Washington, didn’t respond to calls and emails.

The venture into the corporate market began amid the credit crisis in 2008 when 15 of the wealthiest institutions, led by Harvard University, borrowed a combined $7.2 billion to bolster their cash holdings as their endowments declined. Because the financings weren’t tied to any specific educational or research projects, the deals had to be done in the taxable market.

The following year Congress created Build America Bonds as part of the stimulus act, which further whetted the appetite of money managers as states and cities sold $188 billion of taxable municipal debt. While the program, which ended on Dec. 31, 2010, was closed to nonprofits, public institutions such as the University of Virginia sold the federally subsidized debt.

100 Years

The latest wave began last year with MIT’s 100-year bond. At least seven colleges have joined companies and sovereigns such as Mexico in selling the long-maturity debt, including Ohio State University and the California Institute of Technology. As schools considered so-called century bonds, some found taxable rates were also attractive for more conventional 30-year deals, according to Wild at Morgan Stanley.

“It’s not worth the headache, not to mention I can then use those buildings anyway I want to use them,” William G. Laird, chief financial officer at Loyola University of Chicago, said regarding IRS financing restrictions. The school sold a combined $157 million of the debt last month.
The IRS has increased audits and started requiring nonprofits to detail their tax-free financings as part of annual filings to the federal agency, further raising risk of inspection, said Richard Chirls, head of Orrick Herrington & Sutcliffe LLP’s public-finance tax group in New York.

Borrowers can either pay a tax or face penalties if they use their tax-exempt financed facilities for anything outside their educational missions, he said.

Following are pending sales:

SEATTLE MUNICIPAL LIGHT & POWER REVENUE plans to issue about $298 million in tax-exempt revenue bonds and $52 million in taxable revenue debt in a competitive sale as soon as today, according to data compiled by Bloomberg. Proceeds will be used to refund debt. (Added June 26)

NEW YORK STATE THRUWAY AUTHORITY plans to issue $1.1 billion in tax-exempt revenue bonds as soon as today, according to data compiled by Bloomberg. Proceeds will be used to fund capital projects. Standard & Poor’s lowered its outlook on the agency’s debt this month to negative from stable, with an A+ rating, fifth-highest. (Updated June 26)