Fitch: US Senate Tax Proposal Would Pressure US Colleges.

Fitch Ratings-New York-14 November 2017: The Senate Republicans' tax proposal released last week would add incremental pressure to US colleges and universities if made into law in its current form, Fitch Ratings says. The proposal is less onerous than the House proposal but would still raise costs, possibly threaten key funding sources over time and could add to student pressures that might result in lower enrollment.

The Senate proposal differs from the House's as the Senate version would preserve private colleges' and universities' ability to issue tax-exempt private activity bonds (PABs), an important capital financing vehicle for private universities. Eliminating PAB issuance, as the House version proposes, would increase borrowing costs for private institutions. While higher-rated institutions already issue taxable debt for more flexible use of proceeds, we expect this change would reduce the rate of investment in the sector overall and would speed a shift into alternative capital financing structures including private bank placements or internal equity. The Senate and House versions both propose ending tax-exempt advance refundings at the end of this year, which could marginally raise capital costs.

The Senate proposal matches the House's proposed 1.4% excise tax on the net income of certain private college endowments – currently those with more than 500 students and $250,000 per student of assets not related to the organization's tax-exempt purpose. The implementation of this tax is key to its immediate impact as the "The Chronicle of Higher Education" estimates only about 65 institutions would be affected today – generally institutions with financial capacity to manage through a resulting reduction in endowment support for student aid, research and other operating costs.

The impact on endowments would be moderated in any given year by investment returns. Establishment of a framework to tax endowments is credit-negative across the sector, as the rate could be increased or the levy more broadly applied in the future. Both proposals also would change the standard deduction, which could lower the tax benefits of endowment donations.

The Senate proposal is less negative than the House proposal as it retains the student loan interest rate deduction and certain other exemptions and credits related to higher education. In our view, loss of these tax benefits could make colleges more expensive for students. Given heightened emphasis on college affordability, this could mean lower enrollment, especially at regional colleges with very price-sensitive students.

Both proposals would substantially reduce the federal tax deduction for state and local taxes, which would place a practical limit on the tax raising flexibilities of higher tax states. Those states could be forced to make budgetary cuts to maintain their financial flexibility over time if natural revenue growth fails to keep up with expenditure growth. Higher education is generally one of the first things states cut at times of fiscal stress and cuts to appropriations could lead to a decline in an important higher education funding source.

If the Senate bill was made into law today we would not expect these incremental pressures to translate into downgrades for the Fitch-rated universe. The next steps practically ensure the proposals will change. The first step is for the House and Senate proposals to be further amended and reconciled. Thus the final outcome on colleges and universities will remain uncertain through the end of 2017.

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