Minutes[*]

Senate Committee on Finance and Planning
Tuesday, December 18, 2012
2:00 – 4:00
238A Morrill Hall

Present: Will Durfee (chair), Gary Cohen, Dan Feeney, Catherine Fitch, Susan Hupp, Kara Kersteter, Russell Luepker, Jill Merriam, Fred Morrison, Paul Olin, Jahon Rafian, Terry Roe, Michael Rollefson, Ann Sather, Arturo Schultz, S. Charles Schulz, Aks Zaheer

Absent: Lincoln Kallsen, Talha Khan, Ruth Lane, Richard Pfutzenreuter, Gwen Rudney, Kyle Smyth, Thomas Stinson, Michael Volna, Pamela Wheelock

Guests: Kelly Farmer (Director, Tax Management), Channing Riggs (Director, Federal Relations); Carole Fleck (Director, Debt Management)

[In these minutes: (1) tax code implications of budget discussions for higher education; (2) annual debt capacity report]

1. Tax Code Implications of Budget Discussions for Higher Education

Professor Durfee convened the meeting at 2:00 and welcomed Mr. Farmer and Ms. Riggs to discuss the implications of federal and state budget discussions beyond the problem of sequestration, and in particular potential tax law changes. He noted that Ms. Riggs had recently met with the Faculty Consultative Committee (FCC) and had made a couple of comments about potential tax code changes; FCC chair Professor Kohlstedt asked this Committee to have further discussion about those potential changes.

Mr. Farmer had provided information to the Committee before the meeting and said he would summarize the issues. The "fiscal cliff" is nearly upon us, he said, and the discussions include tax law changes. The changes made 10 years ago were not permanent, even though it was thought that some of the provisions were in fact permanent.

One potential change is tuition paid for graduate work on behalf of an employee by an employer; up to $5250 in tuition can be provided tax-free, Mr. Farmer said. The provision (Section 127) expires at the end of 2012; this change would affect ANY employer who provides support to employees for graduate education. The University (all employers) would have to tax the benefit if that provision of the law expires. So the benefit would be counted as income, Professor Luepker concluded. That is correct, Mr. Farmer said, and would be reported on the employee's W-4 form—if an employee uses the benefit. So the effect falls on the employee, not the employer, Professor Durfee observed. Would that mean fewer employees would take graduate work, thus reducing tuition income, Professor Hupp asked? To the extent that employees find the increased cost, it could, Mr. Farmer said, although he noted that the employees are still only paying the tax on the benefit, not the actual tuition.

Professor Zaheer asked what number of people at the University would be affected by the change. Mr. Farmer said he did not know, although he could find out for the Committee if it wished. He surmised that it would be a significant number. Professor Morrison asked how the change would affect Medical

[*] These minutes reflect discussion and debate at a meeting of a committee of the University of Minnesota Senate; none of the comments, conclusions, or actions reported in these minutes represents the views of, nor are they binding on, the Senate, the Administration, or the Board of Regents.

Fellows. Mr. Farmer said there is another section of the code that deals with TAs and RAs, although that would probably not apply to Medical Fellows, so it is likely they would be considered employees—but the provision applies to a tuition benefit, not to payment for work done. Professor Shultz noted that Medical Fellows do not pay tuition and they receive a stipend from the University.

Ms. Kersteter asked how the change would affect TAs and RAs. The provision affecting them remains, in a different part of the tax code, Mr. Farmer said. There is no tax on benefits given to employees in the form of undergraduate education and he has heard no discussion of changing that provision. There is a special exception for TAs and RAs as well, so their tuition benefits are also not taxes. Where a change would apply would be to GAs, such as administrative fellows, who would be subject to the tax.

So will Section 127 be "thrown under the bus," Professor Durfee asked? Ms. Riggs said it was part of the Bush tax cuts and supposedly permanent. What she has been hearing in Washington, she reported, is that Congress cannot solve the "fiscal cliff" with small changes in the tax code and that that is no way to tax policy. She said she does not believe Congress will pick out Section 127 specially but she does believe the Bush tax cuts will expire. The Obama administration takes the position that taxes on high incomes should be raised now and entitlements can be dealt with later; the Republicans take the opposite view.

Mr. Farmer next noted several other tax code provisions that could be changed. The income limits for the American Opportunity Tax Credit (AOTC), an above-the-line deduction for tuition and qualified expenses for lower-income students and families, were increased significantly in 2009; if the changes are not continued, there will be a significant reduction in the number who can take advantage of the opportunity. The change would affect every under-privileged student.

Professor Durfee asked what number of University students would be affected. Mr. Farmer said he did not know the number but said he believed that change would matter to many. It is because of this tax credit that the University gives out 1098 tax forms.

Mr. Farmer reported that the student loan interest deduction is at risk, as is the $2000 Coverdell savings account, which would revert to a $500 limit on tax-free annual contributions. In 2011 the IRA charitable rollover ended (after age 70 and 1/2, one can take out an IRA and donate it to a charitable organization). Professor Durfee asked how this affects the University; Mr. Farmer said the staff in the Foundation could answer that question, but he has a colleague at another Big Ten university who said it was very much affected; presumably the University has seen the same effect.

Also under discussion is the charitable contribution deduction, Mr. Farmer said. Everyone who itemizes on their tax returns knows about that deduction. The effect of reducing or eliminating the deduction would have a significant impact on the University.

Professor Durfee asked Ms. Riggs what strategy the University is taking at this point. Is it that the University goes it alone or works through the national education associations? And with what effect at the federal level? Ms. Riggs said "it depends." The University has provided data to the Minnesota Congressional delegation about research spending and student aid, pointing out that the University would lose about $50 million in research funding in FY13 if sequestration occurs. On the tax questions, the University relies on the associations to carry the arguments.

Professor Luepker said that these issues all seem to be intertwined. If the Bush tax cut package disappears, will all these provisions go with it? If they are not selected out? Ms. Riggs said that

Congress and the White House cannot get to the numbers they need by picking and choosing elements of the tax code—there is a recognition that that does not make a lot of sense. So all the provisions could disappear, Professor Luepker said. They could, Ms. Riggs agreed, at the end of the year—but the situation could be very different on February 1, 2013. There appears to be a move to reach a bargain, but any deal must get through Congress—and it is not clear that it can get through the House.

Mr. Farmer commented that one should not believe that the charitable contributions deduction will disappear in the fiscal cliff negotiations. Congress would have to act affirmatively to eliminate it. But if Congress does not act, Ms. Riggs added, the Bush tax cuts will expire, and some already have. On top of that, there is the possibility of sequestration on January 1.

Under what conditions would that not happen, Professor Zaheer inquired? If Congress and the White House reach agreement to raise a certain amount of revenue, Ms. Riggs said. They can change the rules and move the date of the fiscal cliff. They must also address the debt ceiling—but if the tax cuts disappear, the federal government will have more money, which shifts the date of the discussion of the debt ceiling.

Professor Durfee asked what is happening at the state level. There are some proposals but the legislature would have to act on them before they would come into effect, Mr. Farmer said.

Does anything in current law expire, Professor Durfee asked? Many state tax laws follow federal provisions, Mr. Farmer said, but he did not know of any state provisions that would expire.

So if the deductions are removed from the federal tax code, the state would receive more money, Professor Luepker asked? It would, Mr. Farmer said.

Ms. Riggs said she had asked Vice President Pfutzenreuter where the University's real vulnerabilities lie. He said that they are in research funding and a decrease in funding from the federal government to the state, which would in turn hurt the University's funding.

Professor Roe asked if there has been any reaction at the legislature to the University's biennial request. Ms. Riggs said that it seems to be well-received and that the state may welcome a pathway to hold tuition levels flat.

Professor Durfee asked if there is anything individual faculty, staff, or students can do to help with the message at the federal level, or that would help her. Ms. Riggs said that the University has not planned on what to do if there are federal cuts because it does not know if they will happen. Any stories about the effect of potential cuts would be helpful—now or in the future. They should be provided to her.

Professor Luepker said he was recently in Washington and heard from a program manager at the NIH Heart, Lung and Blood Institute that it was likely the agencies would fund fewer new grants if sequestration occurs, so that the odds of receiving grant funding would drop to about 6%, and that expiring grants would be difficult to renew.

Professor Morrison inquired about the proposal to end or limit the tax benefits of municipal bonds (the income from them is tax-exempt). Mr. Farmer said it is a valuable benefit for public financing. So income to holders of the University's debt would be taxable, Professor Morrison said. Mr. Farmer said the change would only be prospective and said that Ms. Fleck is the expert on how such a change might affect the University's ability to issue its debt.

Ms. Riggs concluded that there is no constituency that rewards Congress for doing what is right. These are very difficult decisions and members of Congress will get in trouble no matter what they do.

Professor Durfee thanked Mr. Farmer and Ms. Riggs for their comments and said that it might beneficial for the Committee to hear from them again later in the spring.

2. Annual Debt Capacity Report

Professor Durfee next welcomed Ms. Fleck to the meeting to provide the annual debt capacity report.

Ms. Fleck distributed copies of a set of slides that she used to make this report to the Board of Regents last week.

The University's long-term debt as of June 30, 2012, is about $1.2 billion, a net increase of about $80 million over the previous year. Most of the debt is in the form of general-obligation bonds and commercial paper, backed by the full faith and credit of the University, and special purpose revenue bonds, which are issued by the University but on which the debt service is paid with an appropriation from the State. A small amount of State Infrastructure Development Bonds issued by the State for the University's one-third share of projects is outstanding, but these will continue to decline because the University has issued its own bonds since 2005 for its one-third share.

Professor Durfee asked what the advantage is to the University to issuing its own debt rather than using the state's program, when the state has a higher rating. The University achieves more flexibility in the timing and structure of its bonds, Ms. Fleck said. The weighted average interest rate for University debt as of June, 2012, is 3.65%. Professor Roe asked what the debt service is on the debt. About $90 million per year, Ms. Fleck responded, of which $30-35 million is interest and the remainder is principal.

Ms. Fleck noted that the $53.6 million of the Gateway Corporation debt, issued for the McNamara Alumni Center, is counted as part of the University's direct debt for rating purposes.

Ms. Fleck reviewed the current amortization schedule through 2018 for the existing debt—assuming no additional debt is incurred. The graph has a downward slope as the principal balance declines. She also reviewed the planned debt issuance for the current fiscal year, totaling approximately $97 million, which includes funding for the Physics and Nanotechnology building and housing projects on the Crookston, Morris, and Twin Cities campuses. FY2014 projected debt issuance totals approximately $62 million, which is comprised of roughly half of the 2013 State Capital Request of $23.8 million, or $11.9 million, and the last tranche of the biomedical facilities totaling $50.5 million. She noted, however, that approximately $38 million of the debt that the University will issue for the biomedical facilities will be special purpose bonds that will be paid for by the state.

Professor Durfee asked how the timing works. Ms. Fleck says they look at a combination of factors, such as funding sources and cash flow of the various projects, and spending requirements when state funds are included. Professor Roe observed that for some activities it is easy to identify a projected income stream (e.g., housing); in other cases that is more difficult. Does that enter the calculations? It does not affect timing, Ms. Fleck said, but it does come into play when they consider self-supporting projects versus those that are not; an academic building such as Physics and Nanotechnology is different from a residence hall. In the case of the former, the University can use any source of funding to pay the debt service including state funding, tuition, and indirect cost recoveries. That is why he inquired about

debt service, Professor Roe said; one can see the revenue stream in some cases but not others. Ms. Fleck said that historically, roughly half of the debt service is covered by self-supporting units and half was not.

Who is on the hook for debt when it is incurred, Professor Luepker asked? Ms. Fleck explained that the external payments are made on required dates, but occupants of the buildings are billed annually based on assignable square footage. The colleges can negotiate with central administration during budget discussions to obtaining financial assistance in paying their share of debt service. In the case of Physics and Nanotechnology, for example, the College of Science & Engineering will be billed.

Professor Zaheer asked if the advantages of flexibility and timing, which the University gains by issuing debt itself rather than using the state's program, outweigh the better state debt rating. They do, Ms. Fleck said, and there is only one level of difference between the University's rating and the state's, which at present does not make much difference in the interest rate paid on debt.

Ms. Fleck next reviewed projected debt balances outstanding (through 2018) for just the debt supported by University resources. The debt is $966 million in FY12, rises to about $1 billion in FY13, and then declines to about $729 million by FY2018. (That assumes, again, that no additional debt other than what has previously been discussed as part of this discussion is issued.) Professor Roe observed that over time, however, the bars on the graph remain at about the same level—the University maintains a fairly constant level of debt. That is correct, Ms. Fleck said. It is always paying off old debt and issuing new.

When decisions are being made about debt, and the University decides it wants to increase its research capacity, and needs facilities to do so, are those facilities funded in a different way, Professor Shultz asked? Ms. Fleck observed that the biomedical research facilities were funded with debt through the Biomedical Science Research Facilities Funding Program, which aims to increase research capacity. Does the University use debt for such things as faculty recruitment, Professor Shultz asked? It does not, Ms. Fleck said; it only uses debt for capital projects. Decisions about funding recruitment and expansion of the research program would be made through the operating budget and through the compact process. That is pretty standard practice across universities, although some institutions are issuing taxable century bonds, whereby the principal is invested and the income earned on the invested principal is used for operating budgets. The University has not seriously considered that option as there is a risk that the principal would be used during the 100 years before it was required to be repaid, and therefore would not be available to pay the principal of the bonds when it came due.

Ms. Fleck then explained the letter ratings used to designate debt quality. Moody's uses (from highest to lowest):

Aaa
Aa1 Aa2, Aa3
A1, A2, A3
Baa1, Baa2, Baa3
etc.

Standard and Poor uses (from highest to lowest):

AAA
AA+, AA, AA-
A+, A, A-
BBB+, BBB, BBB-

etc.

The State of Minnesota is rated Aaa/AA+. The University is rated Aa1/AA. Ms. Fleck explained that Board of Regents' policy provides that the University maintain the double-A category (i.e. Moody's Aa1, Aa2, or Aa3, and Standard & Poor's AA+, AA, or AA-). She has been asked if the University wants to obtain the higher rating, AAA. It could probably do so if it wished, but as of now there does not appear to be a great benefit to doing so—and if one has that rating and then slips, even to the next level down, it can hurt an institution's reputation.

What ratings do the University's peers have, Professor Roe asked. Ms. Fleck said they are mostly Aa1 or Aa2; Michigan and Texas are Aaa.

Ms. Fleck identified the variables that the rating agencies use in determining an organization's rating. They include student demand, state support, the strength of management, and financial statement analysis. Ratios are used to help define debt capacity, but it's important to realize that this is only a small piece of the pie and is not the only factor driving the ratings.

Professor Zaheer asked what factors drop the University from Aaa to Aa1. Ms. Fleck said she did have specific examples of why certain universities are Aaa compared to Minnesota's Aa1 rating. She volunteered to provide to the Committee the reports the University receives from Standard and Poor and Moody's after the next rating. Professor Zaheer suggested the University could ask why the agencies rate Texas and Michigan Aaa and what it takes to get to that rating. He felt it could be useful to learn why the University is kept a notch below the top.

Dr. Fitch asked how often the agencies do ratings. Every time the University issues bonds, Ms. Fleck said, which essentially means an annual review.

How important are these rating levels, Professor Luepker asked. The agencies downgraded U.S. debt last year but the decision seems to have no effect. Ms. Fleck agreed and said that going down a notch really has little effect, at least not in the current market. If an organization were to drop several notches, it would see its debt costs increase. Are these the same agencies that rated the housing financial instruments a few years ago, Professor Luepker asked? They are, Ms. Fleck said. Professor Morrison added that they are also the same agencies that rated Lehman Brothers AA a week before it went bankrupt.

Ms. Fleck outlined the assumptions regarding increases or decreases in specific revenue and expense categories that were built into the forecast model for the years FY2014 though FY2019. Professor Feeney noted the projection of a 2% annual growth in sponsored funding and expressed doubt that that was realistic, given the funding environment.

Given the model, the prediction is that expenses will begin to outrun revenues starting about FY2016, as reflected on a graph that projected both. The projected deficit for FY2016 is about $28 million; but by FY2018 it reaches $137 million.

Professor Morrison said one can see a problem beginning in FY2016. The Committee must ask Vice President Pfutzenreuter how the administration plans to finance the institution in the years starting with FY2016. Professor Durfee recalled that Mr. Kallsen had observed that the University budget must be balanced and that the institution will have to make appropriate adjustments to revenues and expenses for 2014. Ms. Fleck agreed and added that the University will continue to seek additional state funding—

the amount of tuition revenues and state appropriations would obviously affect the slope of the lines on the graph.

Professor Morrison also observed that if federal funds are cut, the University may have to use balances to keep projects going, and the Committee may need to advise the administration on that point. Professor Shultz reported that the dean of the Medical School has laid out a plan to increase research, and that includes not closing labs or research programs that have proven to be excellent investments.

Professor Zaheer asked if there are any public or private institutions where the administration plays the role of central bank that loans money to programs for whatever purposes seem worthwhile. Ms. Fleck said the University does do some central banking in that it provides loans to units for capital projects and the units pay back the loans with interest on an agreed-upon schedule.

Ms. Fleck summarized three key financial metrics that rating agencies use and explained where the University stands on each of them. In all three cases, the University is at or near the top of the range of the ratio and its trends are in the right direction.

The theoretical debt capacity of the University is greater than its current debt outstanding, Ms. Fleck told the Committee, based on the Aa1 median rating from Moody's. If the University wished to be aggressive, in theory it could issue as much as $3.7 billion in debt by 2018 under the current assumptions built into the forecasting model. However, the University is not likely to issue debt to its full capacity, and ultimately the question really comes down to the ability to pay the debt service.

Other factors that will affect the University's debt capacity in future years are the six-year capital plan, which would add debt issuances in years beyond FY2014, the Ambulatory Care Clinic, which will involve $132.5 million in debt (since decisions have not been made as to timing of the issuance, that amount was not included in any of the calculations reflected in this presentation), and the Combined Heat and Power Plant, of which the cost of the project depends on the size of the turbine, which affects the amount of energy savings.

So based on current projections, there is additional capacity for debt, Ms. Fleck summarized, but the University must keep an eye on its ability to pay.

Professor Morrison asked if the Gateway bonds are taxable, and if so, should the University think about buying the Gateway Center and getting rid of the corporation. Would that be a good move? If the bonds are on the taxable market, they may be at a higher interest rate. Mr. Farmer reported that the corporation is a 501(c)(3) organization, so tax exempt. He did not know if it had the same rating as the University or the same interest rate on the debt.

Professor Olin asked what the average length of University debt is. About ten years because the University pays it down quickly, Ms. Fleck said. Could the University take longer because of the low interest rates, he asked? They have talked about the possibility of extending the debt repayments but have not done so at this time, Ms. Fleck said.

Professor Durfee thanked Ms. Fleck for the presentation of the material and said it is clear that the University has good financial managers. He adjourned the meeting at 3:30.

-- Gary Engstrand

University of Minnesota