September 8, 2026

Proposed IRS Rule Targets Tax-Exempt Status for Private Schools

On the Hill

On September 3, 2026 the Internal Revenue Service and the U.S. Department of the Treasury published proposed regulations (REG-119986-25, RIN 1545-BS05) that would disallow tax-exempt status under Section 501(c)(3) of the Internal Revenue Code of 1986 (the "Tax Code") for any private school that discriminates on the basis of race, color or national or ethnic origin in the administration of any educational policy, admissions policy, scholarship or loan program, athletic program or other school-administered or school-supported program.

The proposed regulation defines "private school" broadly to include any private primary or secondary school, college, professional or trade school or university that is described in Section 501(c)(3) and classified as an educational organization under Section 170(b)(1)(A)(ii) of the Tax Code. Public schools are excluded from the proposed regulation's purview.

The proposed regulation would impose a year-by-year nondiscrimination test. For taxable years beginning after May 31, 2027, a private school that "adopts, maintains, or enforces any policy or practice that discriminates on the basis of race, color, or national or ethnic origin" in the administration of any educational, admissions, scholarship or loan, athletic or other school-administered or school-supported program would not be treated as tax-exempt for that year. Because the test is annual, a school that changes its policies could potentially regain exempt status in a later year. The "for any purpose" standard would include policies defended as remedial or diversity-related, and the proposal would modify Rev. Proc. 75-50 (as modified by Rev. Proc. 2019-22) by deleting provisions that permitted preferences for racial minority groups in admissions, programs, facilities or financial assistance.

The proposal includes an express religious carve-out: private schools may maintain a religious mission, curriculum or program of observance and may select students based on religious affiliation or membership, so long as the criteria are based solely on religion and not shared ancestry or ethnic characteristics.

The IRS estimates that approximately 18,000 private schools and 750,000 students may be affected. A 60-day public comment period will follow publication in the Federal Register, and the IRS will schedule a public hearing if requested.

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What This Means for Tax-Exempt Bonds

Although the proposed regulation focuses on private-school tax-exempt status and does not directly address second-order or downstream effects on the bond markets, the practical implications could be significant. Qualified 501(c)(3) bonds frequently finance capital projects for nonprofit universities and other qualifying charitable educational institutions. The interest received by investors holding such bonds is typically exempt from gross income of those investors for federal income tax purposes. However, one significant condition to maintaining such tax-exempt treatment of interest is continued status of the benefiting borrower as an organization described in Section 501(c)(3) of the Tax Code. The indirect but impactful consequence of the proposed regulations to investors holding such bonds is the loss of federal tax exemption that such investors currently enjoy. As currently written, the proposed regulations would affect all existing investors of such bonds and are not limited to prospective new issuances of bonds going forward. This impact on investors, especially the lack of prospective application to new issuances of bonds, is likely to cause severe consequences to charitable nonprofit educational institution borrowers which may face resulting covenant defaults when interest paid becomes taxable to investors.

The delayed effective date of May 31, 2027 gives institutions time to adjust their policies but also creates an interim period of uncertainty for bondholders, issuers and other market participants, and does not address the consequence to existing investors of tax-exempt bonds.

Bond counsel, underwriters and issuers should evaluate their potential exposure, review relevant tax-exempt-status covenants and representations, and monitor affected institutions' compliance and policy changes. While the regulation focuses on educational 501(c)(3) entities, it could be a harbinger of future regulations which might be adverse to 501(c)(3) organizations in other sectors.

What's Next

The proposed regulation is now subject to a 60-day public comment period following its publication in the Federal Register. The IRS has indicated that a public hearing will be scheduled if one is requested. Several higher education groups have already signaled their intent to oppose the rule.

As always, we will continue to monitor both the progress of this proposed regulation and any related legislative or regulatory developments closely, and we will provide updates as new information becomes available. We encourage our clients and colleagues in the tax-exempt bond community to reach out with questions or to discuss any potential impacts on their programs or transactions.