

June 27, 2007

Statement Regarding Unrelated Debt Financed Income and "Blocker Corporations"

Concern has been expressed about the use of foreign corporations (so-called "blocker corporations") by U.S. tax-exempt organizations to invest in domestic U.S. hedge funds. Without the use of blocker corporations, a portion of the income that exempt organizations receive from hedge funds would be subject to tax as unrelated business income due to section 514 of the Internal Revenue Code, which imposes UBIT on certain leveraged investments. This paper provides background information on the origin and purpose of the restrictions on debt-financed property under which tax-exempt organizations must operate and on how those rules affect investment decisions.

When Congress added the tax on unrelated business income to the Internal Revenue Code in 1950, it added as well separate rules limiting the ability of charitable organizations to leverage their investments by the use of borrowed funds. The primary reason for adoption of the debt-financed property rules was that some charities were using their tax exemptions inappropriately—virtually “marketing” those exemptions—to generate fees or commissions for assisting for-profit businesses in abusive tax minimization strategies. Because the first version of the “unrelated debt-financed income” rules was largely ineffective to prevent these abuses, the debt-financed income rules were rigorously tightened by the Tax Reform Act of 1969.

In the period since 1969, the capital markets have developed a broad range of increasingly-sophisticated investment vehicles. Although many involve some use of debt, these investments are not the sham transactions the debt-financed property rules were designed to prevent. Nonetheless, the application of the debt-financed property rules impedes the ability of tax-exempt organizations to include these investments in their portfolios. Recognizing this, Congress and the Internal Revenue Service have determined that certain investment vehicles, such as securities lending transactions, should not be subject to the debt-financed property rules even though the transactions involve some debt. Further complicating the picture, Congress has also exempted qualifying real property investments from the debt-financed property rules, but only when those investments are made by universities and pension funds; other tax-exempt investors, including foundations, remain subject to tax on leveraged investments in real property.

Congress enacted the debt-financed property rules primarily to prevent a type of transaction that used a charitable organization to convert, in effect, ordinary business income into gains that could be taxed at lower rates as capital (or quasi-capital) gains. These “bootstrap sales” followed this general pattern: A for-profit corporation would “sell” income-producing assets to a charitable organization, which would buy the assets by borrowing the necessary funds through a nonrecourse installment note provided by the

seller.¹ The charitable organization would then “lease” the assets (which of course were never physically transferred to the charitable buyer) back to the seller, charging rent that would, because it was deductible by the for-profit seller/lessee, largely offset the otherwise taxable business income that would be produced by the use of the assets. The rental payments would slightly exceed the amount of the buyer/lessor’s installment payment obligation each year, providing a spread that compensated the charitable organization for its trouble in participating in this largely illusory transaction. For the putative seller/lessee, the object was to convert ordinary business income into capital gain--cleansing that income of its ordinary character by claiming to pass it briefly through the charitable organization. The transaction required a tax-exempt organization to fill the putative buyer/lessor role, because any nonexempt party would have been taxable on the rent payments, which would have meant that the ordinary business income would only have been transferred to another taxpayer, rather than being made to disappear altogether, as it effectively did when it was received by an exempt entity.

Though this type of transaction seems transparently abusive, a divided Supreme Court allowed the business taxpayer in such a transaction to report capital gain income on the putative sale of its assets (rather than ordinary income from the continued use of the assets, as the Commissioner had argued) in the well-known “Clay Brown” case (Commissioner v. Brown, 380 U.S. 563 (1965)). A later Tax Court case (Commissioner v. University Hill Foundation, 51 T.C. 548 (1969)) held that a charity that had participated in a series of Clay Brown transactions did not have unrelated debt-financed income as a consequence.² These sale-leaseback transactions, buttressed by the Brown and University Hill Foundation court precedents, were cited by Congress in 1969 as justifications for its enactment in that year of provisions that broadly strengthened the unrelated debt-financed income rules of §514 of the Code.³

That response may well have been excessively broad. Investment portfolios maintained by taxable individuals and entities often make judicious use of debt to enhance returns, in ways that cannot be described as abusive of any tax rules. Charitable organizations’ use of debt likewise did not (prior to 1969) and would not (if allowed today) necessarily involve any abuse of the sort represented by the Clay Brown model. Further, a number of post-1969 changes to the tax law that have nothing to do with charitable organizations would generally make Clay Brown transactions either uneconomic or pointless today. The most significant among these is the fact that corporations no longer enjoy rate preferences on capital gain income, which obviates any attempt to convert ordinary business income into capital gain in most cases. Taxpayers in special circumstances might still benefit from such

¹ The de facto asset purchase was usually structured as a purchase of stock, followed by a liquidation of the company. The assets were then leased to a new company controlled by the historic shareholders of the old company. (This permitted the capital gains to be taxed at the shareholder level rather than at the corporate level, avoiding under the rules applicable at the time a second layer of taxation.)

² This decision was later reversed on other grounds (446 F.2d 701, 9th Cir. 1971); but it was, in its Tax Court form then extant, influential in the debates surrounding the Tax Reform Act of 1969. See S. Rep. No. 552, 91st Cong., 1st Sess. 62-63, reprinted in 1969 U.S.C.C.A.N. 2027, 2091-92.

³ Id.

a strategy were it not for the unrelated debt-financed income rules.⁴ However, nothing in the hedge-fund investment strategies described below remotely resembles a Clay Brown scenario.

Charitable organizations, particularly universities, foundations, and pension funds, have in recent years begun to invest substantial sums in hedge funds. Hedge funds are pools of assets that are invested in pursuit of a variety of strategies including short sales of borrowed stock; efforts to exploit the arbitrage opportunities created by extraordinary corporate events (such as tender offers, spin-offs, etc.); currency swaps; notional principal contracts; and several others. Together with other alternative investments, hedge funds allow investors to diversify their portfolios, enhance yields and enhance the preservation of capital in down markets. From an investment viewpoint, these strategies have been very successful, producing returns that have generally exceeded overall market performance measures in both rising and falling markets.

Nonprofit organizations that invest directly in hedge funds face a problem, however, in structuring their investments in ways that do not create exposure to unrelated debt-financed income tax liabilities under the rules of §514. Hedge funds often make use of borrowed funds in some of their investment strategies, especially those involving arbitrage. And, because hedge funds are usually organized as limited partnerships, that borrowing may be imputed to their partners, including any charitable organizations that may be limited partners. If a hedge fund were organized as a corporation, it could freely use debt in pursuit of its investment strategies, and still pay dividends to charitable stockholders that would not be characterized as unrelated debt-financed income. However, operating through a corporate structure would generate income tax liabilities at the entity level that are otherwise completely avoidable and which would be unacceptable to the fund's non-exempt investors.

To address this problem, hedge funds have created foreign corporations in low-tax jurisdictions. These corporations, in turn, invest in limited partnership hedge funds—typically in funds organized and operated within the U.S. The foreign corporations under these arrangements pay little corporate income tax in the countries in which they are incorporated (because of the very low rate structures generally prevailing in those countries). However under a series of private letter rulings from the Internal Revenue Service, the dividends they distribute to their charitable shareholders are free of any debt-financed income taint.⁵

As Congress considers the use by tax-exempt organizations of offshore corporations to invest in hedge funds, consideration should be given to the underlying question of whether the debt-financed property rules should apply to hedge fund investments. If the debt-financed property rules did not apply, tax-exempts would be able to invest directly in US hedge funds. The unrelated debt-financed income tax, like its close relative the unrelated

⁴ For example, a corporate taxpayer with substantial unabsorbed capital losses might wish to generate artificial capital gains if it could, since such gains could be netted with the pre-existing capital losses, which cannot be done with ordinary income.

⁵ E.g., Ltr. Rul. 200251018.

business income tax, is primarily designed to assure that a tax in lieu of a corporate income tax is paid on income that would ordinarily be expected to generate corporate income tax liabilities—income generated by business or debt-financed activities regularly carried on by entities subject to those taxes. The legislative history of the 1969 Act is abundantly clear on this point: protection of the integrity of the corporate income tax, and its ability to generate revenue, were the goals of these provisions. At the same time, Congress expressly exempted most passive investment income received by tax-exempt entities from the unrelated business income tax.⁶ This exemption extends both to income that was subject to tax at the corporate level (dividends), but also to income (rents, royalties, capital gains) upon which no corporate tax was paid. The income of hedge funds is not ordinarily exposed to corporate-level taxation, due to the widely accepted structuring of such funds as limited partnerships. Individual investors in such funds are and should be liable for taxes on the income of the funds; but since charitable entities are normally not liable for taxes on income from their investments, they should not be so taxable on investment income generated by hedge funds. The use of blocker corporations effectively achieves this result, but the use of blockers would not be necessary if the tax were not construed as applying to these investments.

If statutory amendments effectively prohibit charitable organizations from using foreign corporations to avoid the unrelated debt-financed income rules, but the debt-financed income rules are not amended to allow charities to make such investments directly, charitable organizations will face an unfortunate strategic choice: they may make direct investments in hedge funds that use the full range of investment strategies, knowing that such a choice will likely subject them to significant unrelated debt-finance income taxes, or they may avoid hedge fund investments entirely, leaving their portfolios less balanced than they would be with the inclusion of hedge funds. Finally, if there is sufficient interest on the part of hedge fund managers, it might be possible to establish alternative hedge funds that carefully eschew the use of debt.⁷ The latter strategy would avoid tax liabilities, but may also reduce investment returns by diminishing the range of investment options available to these funds.

We think it is unlikely that tax-exempt organizations would continue to invest in hedge funds if the returns from the fund become subject to UBIT due to the application of the debt-financed property rules. There are several reasons for this. First, avoiding the unrelated debt-financed income tax would represent a savings that would be tangible and certain, while the additional returns that might be available through leveraged investment strategies would always be uncertain and conditional. Second, the unrelated debt-financed income tax rules create unacceptable compliance burdens due to their complexity, and in some situations may, because of their computational mechanics, effectively extend the reach of the tax even to returns that cannot fairly be described as debt-financed. Third,

⁶ Section 512(b) excludes from taxation, for example, dividends, interest payments, annuity payments, royalties, most rents and most capital gains.

⁷ It appears that the IRS is willing to permit the use of some incidental, transactional debt relationships inherent in the use of strategies such as short sales, in which the investor typically borrows stock for purposes of the short sale, replacing it later with newly purchased stock. There are, however, significant ambiguities in the IRS position on these questions that would need to be clarified if the IRS position permitting use of foreign corporations were to be reversed by legislation.

there is a sense in the charitable field that generation of unrelated business or debt-financed income tax liabilities is something of a mark of shame, a penalty for behavior that is contrary to the charitable purposes of the organization.

If this response is general among charitable organizations, it would have one very important implication: it would mean that any legislative changes to the current arrangements would generate little if any additional revenue. Rather than paying an unrelated debt-financed income tax, charitable organizations will likely rearrange their portfolios in ways that avoid the tax, possibly at the cost of somewhat diminished investment returns.

The issue of the use of offshore blocker corporations in hedge fund investments illustrates the need for Congress to review the continued need for the debt-financed property rules in light of other changes to the Tax Code and the distorting effect of the rules on investments by tax-exempt organizations. An additional reason for undertaking such a review is to address the disparity in the current exemption for investments in debt-financed real property, which excludes only investments made by universities and by pension plans and not those by other tax-exempt organizations including foundations. There is no apparent policy reason for this distinction, which unfairly disadvantages efforts by foundations to manage and diversify their portfolios through the inclusion of investments in real property.