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The Use of Offshore Blocker Corporations by U.S. Nonprofits: Should Blockers Be Blocked?

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Abstract: Many U.S. nonprofits use offshore blocker corporations to avoid paying the debt-financed unrelated business income tax (UBIT). Some lawmakers and commentators, however, criticize the practice as abusive. This article takes a closer look at the issue. It concludes that the use of offshore blocker corporations does not undermine the main purposes of the debt-financed UBIT, but that the practice nevertheless raises some serious policy concerns. The article thus recommends that Congress reform this tax: either by eliminating the blocker corporation workaround to the debt-financed UBIT or, alternatively, by repealing the debt-financed UBIT completely but leaving in place or even expanding the debt-financed UBIT's reporting requirements.

Keywords: UBIT, UBTI, tax haven, blocker, tax

1 Introduction

Like their for-profit counterparts, tax-exempt American nonprofit organizations sometimes set up, manage, and/or invest money in foreign legal entities.[1] In some instances, the use of foreign entities by nonprofits is clearly benign and, from both a legal and a policy standpoint, unobjectionable. A nonprofit's mission, for example, may be to provide services outside the United States, and to accomplish this mission, a nonprofit may have no choice but to use subordinated or affiliated foreign legal entities. In other instances, however, the permissibility or desirability of using foreign legal entities may be less clear, as some lawmakers and commentators have suggested is the case with nonprofit investment in "offshore" funds, i.e., funds organized in a foreign tax haven

1 This article focuses on public charities and private foundations, the largest category of nonprofit entities that enjoy federal tax exemption. But the analysis may also apply to other tax-exempt entities, for instance, pension funds.

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jurisdiction.[2] Nonprofit organizations frequently invest in offshore rather than domestic investment funds to avoid incurring federal income tax liability, i.e., the debt-financed unrelated business income tax (UBIT), and the additional income tax reporting obligations that go along with it. Under current law, such tax structuring is legal. But there has been debate on whether the practice is proper and should continue to be permitted in the future.

This article looks at the use of foreign blocker corporations by public charities and private foundations organized in the United States, i.e., tax-exempt nonprofit organizations registered under I.R.C. § 501(c)(3), to avoid the debt-financed UBIT. The article forms part of a larger project exploring whether, as critics have argued, offshore operations by nonprofits amount to illegitimate "gaming" or instead merely represent "navigation" of the current legal and tax regime. "Gaming" is a term that suggests that nonprofits exploit weaknesses in laws designed to protect the public and the public fisc. "Navigation," in contrast, is a term that suggests that nonprofits, buffeted by a cumbersome tax and governance regime, use legal structures to negotiate a difficult path toward accomplishing their missions.

What we argue below is that permitting the use of foreign blocker corporations does not undermine the original purposes of the debt-financed UBIT, but that it nevertheless does raise some policy concerns. The majority of nonprofits that operate internationally have good reasons for doing so, and this is true as well for those nonprofits that invest in offshore investment funds. Nevertheless, permitting the use of foreign blocker corporations to avoid the debt-financed UBIT may be problematic because it incentivizes nonprofits to invest through offshore rather than domestic vehicles and makes nonprofit investments less transparent.[3] Congress might thus want to consider reforming this area of nonprofit tax law. Congress could address these concerns by blocking the use

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2 *See, e.g.*, Rick Cohen, "Senator Grassley Proposes New Nonprofit Regs Thanks to Investigation of the Boys and Girls Club," *Nonprofit Quarterly*, April 19, 2015, https://nonprofitquarterly.org/updates/14406-senator-grassley-proposes-new-nonprofit-regs-thanks-to-investigation-of-the-boys-and-girls-clubs.html; Doug Donovan, "Maryland Nonprofits Investing in Offshore Accounts," *Baltimore Sun*, December 13, 2014, http://www.baltimoresun.com/news/maryland/bs-md-cayman-islands-20141213-story.html#page = 1 (accessed July 4, 2015); Peter Panepento, "Nonprofit Groups May Be Affected by Review of Offshore Tax Shelters," *Chronicle of Philanthropy*, July 23, 2008, https://philanthropy.com/article/Nonprofit-Groups-May-Be/194371; Stephanie Strom, "Nonprofits Face Threat to a Tax Loophole," *N.Y. Times*, May 16, 2007, http://www.nytimes.com/2007/05/16/us/16hedge.html?_r=0 (accessed July 4, 2015).

3 *Cf.* David S. Miller, "How US Tax Law Encourages Investment Through Tax Havens," *Tax Notes*, April 15, 2011, http://www.taxanalysts.com/www/features.nsf/Articles/86F0282D165D18B5852578730054F262?OpenDocument (accessed July 4, 2015).

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of foreign blocker corporations to avoid debt-financed UBIT, as some lawmakers have proposed. Or Congress could instead repeal the debt-financed UBIT rules but leave in place and even expand current reporting requirements for leveraged investments.

This article consists of four main parts. Section 2 reviews the international activities of nonprofits and how they may lead to monetary transfers to foreign legal entities. Section 3 then looks at how the debt-financed UBIT encourages nonprofits to invest in tax haven jurisdictions. Section 4 considers whether the use of blocker corporations should be viewed as gaming or navigation of the legal and tax regime. Finally, Section 5 provides some suggestions as to how the current debt-financed UBIT regime, together with the use of blocker corporations, could be reformed.

2 International Operations

A significant number of nonprofits in the United States – whether public charities or private foundations – have international activities at the core of their mission. According to the Urban Institute, around 5600 public charities, i.e., organizations registered under I.R.C. § 501(c)(3) that are not private foundations, operated in the international nonprofit subsector in 2003[4] and around 6100 operated in that subsector in 2012.[5] These internationally oriented public charities comprise just a small fraction of the entire U.S. nonprofit sector. In 2012, for instance, public charities with international missions made up only around 0.63% of all registered 501(c)(3) organizations and only around 1.8% of 501(c)(3) organizations that filed Form 990 with the I.R.S.[6] Nevertheless, these public charities still spend substantial resources, both privately donated and publicly supported, and exercise far-reaching influence on international

4 Janelle A. Kerlin and Supaporn Thanasombar, *The International Charitable Nonprofit Subsector: Scope, Size, and Revenue 1*, Urban Institute Policy Brief 2, September 2006, http://www.urban.org/UploadedPDF/311360_nonprofit_subsector.pdf (accessed July 4, 2015); Elizabeth J. Reid and Janelle A. Kerlin, *The International Charitable Nonprofit Subsector in the United States: International Understanding, International Development and Assistance, and International Affairs* 7, The Urban Institute, January 18, 2006, http://www.urban.org/UploadedPDF/411276_nonprofit_subsector.pdf (accessed July 4, 2015).

5 Brice S. McKeever and Sarah L. Pettijohn, *The Nonprofit Sector in Brief 2014*, at 6, The Urban Institute, Oct. 2014, http://www.urban.org/UploadedPDF/413277-Nonprofit-Sector-in-Brief-2014.pdf (accessed July 4, 2015).

6 *See id.* at 3, 6, 8.

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activities, particularly in the areas of international development and assistance, promoting international understanding, and international affairs.[7] In 2003, public charities with international operating missions brought in $17.7 billion of revenue, and in 2012 they brought in $29.3 billion of revenue.[8]

Like many public charities, many private foundations also engage in international activity. Grant making foundations organized in the United States dominate international giving.[9] A study by the Foundation Center found that 60% of its sample of 1330 larger U.S. foundations, which accounted for roughly half of all foundation giving, made at least one international grant.[10] The total amount of international grant making by the private foundations in the study came to $4.3 billion for 2010, down from $6.3 billion in 2008.[11] Private foundation grants went to a wide variety of causes, but particularly to improving global health, alleviating poverty, protecting the environment and preventing climate change, promoting democracy, and improving global security.[12]

Because of their international mission, nonprofits operating in the international nonprofit subsector frequently deploy their resources abroad through foreign corporate or trust forms. An internationally oriented nonprofit, for instance, might create a foreign corporate subsidiary to segregate liability, in the same way that for-profit entities use separate legal entities to limit the contractual and tort liability that can arise from any of their projects.[13] Another reason why a nonprofit with an international mission might create a foreign subsidiary is legal and tax-related.[14] A number of countries grant charitable deductions only to contributions that are made to domestically organized

7 Kerlin and Thanasombar, *supra* note 4, at 2–3; Reid and Kerlin, *supra* note 4, at 2.

8 Kerlin and Thanasombar, *supra* note 4, at 8; Reid and Kerlin, *supra* note 4, at 2; McKeever and Pettijohn, *supra* note 5, at 6.

9 Brian Pratt et al., *Understanding Private Donors in International Development*, July 5, 2012, http://www.intrac.org/data/files/resources/747/Briefing-Paper-31-Understanding-private-donors-in-international-development.pdf (accessed July 4, 2015).

10 *International Grantmaking Update: A Snapshot of U.S. Foundation Trends* 1, 3, Foundation Center, December 2012, http://foundationcenter.org/gainknowledge/research/pdf/intl_update_2012.pdf (accessed July 4, 2015).

11 *Id*.

12 *Id*. at 4–5; *see also* Joan E. Spero, "The Global Role of U.S. Foundations," 2010, http://foundationcenter.org/gainknowledge/research/pdf/global_role_of_us_foundations.pdf (accessed July 4, 2015).

13 "New York State Bar Association, Tax Section, Report on Tax Deductibility of Contributions to Disregarded Entities Owned by Charities 19," Report No. 1254, January 12, 2012 [hereinafter Report on Tax Deductibility].

14 *Id*.

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charities or to select foreign charities.[15] A nonprofit might also create a foreign subsidiary for local business purposes, for instance, so that it can open a local bank account.[16]

However, nonprofits without central international missions also engage in activities abroad – particularly by investing in offshore alternative investment funds like hedge funds and private equity funds. Definitions of "alternative investments" vary widely,[17] but they are generally agreed to include such non-traditional assets types as hedge funds, private equity, and structured products (e.g., collateralized debt obligations, credit derivatives) and sometimes are also defined as including real estate and commodities.[18] The term "hedge fund" covers a wide variety of investment funds with different investment strategies, but, broadly speaking, refers to an investment pool that is not traded on a public market, is available only to high net worth individuals and institutional investors, and seeks to generate positive returns regardless of market conditions.[19] A private equity fund, on the other hand, can be broadly defined as an "entit[y] formed for the purpose of making investments in securities or other assets that are not readily tradable or that are otherwise known as 'illiquid' assets."[20]

The number of U.S. nonprofits that invest in offshore alternative investment funds is unknown. But the number is probably substantial. According to NACUBO, U.S. colleges and universities, which constitute one of the most substantial portions of the nonprofit sector by revenue, allocated 53% of their endowments by dollar-weighted average[21] and 28% by equal-weighted average

15 *See, e.g.*, Jeff Gray, "Canada Revenue Agency Delists Foreign Charities," *The Globe and Mail*, August 18, 2014.Accessed November 9, 2014. http://www.theglobeandmail.com/report-on-business/industry-news/the-law-page/canada-revenue-agency-delists-foreign-charities/article20104693/; Canada Revenue Agency, "Foreign Charitable Organizations That Have Received a Gift from Her Majesty in Right of Canada," October 29, 2014. Accessed November 9, 2014. http://www.cra-arc.gc.ca/chrts-gvng/qlfd-dns/gftsfrmhrmjsty-eng.html.

16 "Report on Tax Deductibility," *supra* note 13, at 19.

17 Mark J.P. Anson et al., *CAIA Level I: An Introduction to Core Topics in Alternative Investments* 3 (2nd ed. Hoboken, N.J.: Wiley, 2012).

18 *See id*. at 3–8.

19 Scott J. Lederman, *Hedge Fund Regulation* § 1:3 (2nd ed.) (New York: Practising Law Institute, May 2014).

20 Stephanie R. Breslow and Phyllis A. Schwartz, *Private Equity Funds: Formation and Operation* § 1:2.2 (New York: Practising Law Institute, June 2014).

21 2013 NACUBO-Commonfund Study of Endowments, Number of Respondents to the NACUBO-Commonfund Study of Endowments, and Total Endowment Market Values, Fiscal Year 2013, by Endowment Size and Institution Type, http://www.nacubo.org/Documents/EndowmentFiles/2013NCSEPublicTablesRespondentsbySizeofEndowmentRevisedJan232014.pdf (accessed July 4, 2015).

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to alternative investment strategies in the fiscal year 2013.[22] (The total value of the college and university endowments in the NACUBO survey was $448.6 billion in 2013.) Given the adverse tax consequences of investing in many onshore alternative investment funds, much of the money allocated to alternative investment strategies is probably invested offshore. Offshore investment by nonprofits thus probably can be reckoned in at least the hundred billion.[23]

3 Debt-Financed UBIT and Offshore Investment

The main reason why nonprofits without central international missions invest offshore is to invest in hedge funds, private equity funds, and various other alternative investment funds without incurring federal income tax liability and additional income tax reporting obligations. In general, the Federal Internal Revenue Code exempts nonprofits from income taxation.[24] Most nonprofit organizations must file an annual Form 990, 990-EZ, 990-N, or 990-PF with the Internal Revenue Service, but do not need to fill out other tax-related paperwork or pay federal income taxes.[25] However, the Federal Internal Revenue Code has an exception for the “unrelated business income tax” (UBIT).[26] This tax extends to two types of income. First, it applies to a nonprofit’s “unrelated business taxable income,”[27] which is defined as gross income from an unrelated trade or business minus the deductions directly connected with the trade or business.[28] Second, the UBIT applies to a nonprofit’s passive income to the extent that the

22 2013 NACUBO-Commonfund Study of Endowments, Asset Allocations for U.S. College and University Endowments and Affiliated Foundations, Fiscal Year 2013, http://www.nacubo.org/Documents/EndowmentFiles/2013NCSEPublicTablesAssetAllocations.pdf (accessed July 4, 2015).
23 One estimate for 2006 placed investment by the entire U.S. tax-exempt sector in offshore hedge funds at $503.5 billion. Martin A. Sullivan, “Offshore Explorations: Caribbean Hedge Funds, Part 2,” *Tax Notes* 118 (2008): 255, 258. So the amount that today tax-exempts invest in all offshore alternative investment funds should be comparable, if not larger. The exact amount invested by tax-exempt nonprofits in offshore alternative investment funds, however, is an open question.
24 I.R.C. § 501(a).
25 *Which Forms Do Exempt Organizations File?*, I.R.S., July 3, 2014. Accessed December 1, 2014. http://www.irs.gov/Charities-&-Non-Profits/Form-990-Series-Which-Forms-Do-Exempt-Organizations-File%3F-(Filing-Phase-In).
26 I.R.C. § 501(b).
27 *Id.* § 511.
28 *Id.* § 512(a)(1).

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investment in the income producing property is debt-financed.[29] If a nonprofit takes on debt to acquire investment property, it must pay UBIT on the income derived from the debt-financed portion of the property[30] less a proportional amount of the deductions connected to the property.[31] If the gross income from a nonprofit's unrelated business taxable income and debt-financed unrelated business taxable income exceeds $1,000, it must file Form 990-T with the Internal Revenue Service.[32]

Hedge funds, private equity funds, and other alternative investment funds that frequently employ financial leverage are attractive to many larger nonprofits and for-profit investors because these investments have a high risk-adjusted return. But these investments also pose special tax-structuring challenges for nonprofits because of the debt-financed UBIT. To avoid the corporate income tax, alternative investment funds generally elect to be treated as pass-through entities for U.S. tax purposes.[33] However, under current federal income tax law, a nonprofit will incur debt-financed UBIT not only when it itself takes on debt to acquire investment property, but also when it invests in a pass-through entity and the pass-through entity acquires income producing property by means of debt financing.[34]

Nonprofits are able to avoid incurring debt-financed UBIT with such investments if they employ a so-called "blocker" corporation. If a nonprofit invests in an entity that is treated as a corporation for tax purposes and that entity borrows money to acquire investment property, the dividends that the corporation pays

29 *Id.* § 512(b)(4).

30 *Id.* § 514(a)(1) ("There shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness ... for the taxable year with respect to the property is of (B) the average amount ... of the adjusted basis of such property during the period it is held by the organization during such taxable year.").

31 *Id.* § 514(a)(2) ("There shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying ... the percentage derived under paragraph (1) to the sum determined under paragraph (3).").

32 *Unrelated Business Income Tax*, I.R.S., October 15, 2014. Accessed December 1, 2014. http://www.irs.gov/Charities-&-Non-Profits/Unrelated-Business-Income-Tax.

33 For an overview of the tax structuring of alternative investment funds, see Samuel D. Brunson, "Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income," *Northwestern University Law Review* 106 (2012): 225, 236–37.

34 *Revenue Ruling* 74–197 (1974): 1974–1 C.B. 143.

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out to the nonprofit will not be subject to UBIT.[35] The non-pass-through character of the corporation "blocks" the debt-financed character of the underlying income.[36]

For a blocker corporation to make financial sense, however, it must be organized in a non-U.S. tax haven jurisdiction, i.e., a foreign jurisdiction with a low or zero corporate tax rate like Bermuda, the Cayman Islands, or Jersey. A nonprofit organization does not need to pay tax on the dividends it receives from a blocker corporation (unless it borrowed money to invest in the blocker corporation). But because of the corporate income tax, a blocker corporation organized in the United States will still have to pay corporate level taxes on its own income. A blocker corporation organized in a foreign tax haven jurisdiction, in contrast, will generally have little to no tax liability. Such a blocker corporation will owe little to no corporate income tax in its home jurisdiction and generally little to no U.S. income tax as well. A foreign corporation is subject to U.S. income tax only on income effectively connected with a U.S. trade or business[37] or on income that is U.S. source income.[38] In particular, income from offshore hedge funds often falls into neither category and even when it does, various rules can allow a foreign blocker corporation to avoid paying or withholding U.S. income tax.[39]

4 Gaming or Navigation?

There has been much debate on whether the use of foreign blocker corporations to avoid debt-financed UBIT should be viewed as gaming or navigation of the legal and tax regime. On the one hand, the Internal Revenue Service in private letter rulings has explicitly approved this approach to tax planning,[40] which is consistent with

35 Miller, *supra* note 3.
36 *Id.*
37 I.R.C. § 882(a)(1).
38 *Id.* § 881.
39 Emily Cauble, "Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities," *Virginia Tax Review* 29 (2010): 695, 707 no. 39 ("Capital gain income earned by a non-U.S. person would not generally constitute U.S. source income. See I.R.C. § 865(a)(2). Furthermore, while dividend income or interest income paid by a U.S. company in which the hedge fund invests likely would constitute U.S. source income potentially subject to withholding, interest income earned by hedge funds will often be entitled to an exemption from withholding provided for portfolio interest. See I.R.C. §§81(a), 861(a)(1), 861(a)(2), 881(c).").
40 I.R.S. Private Letter Ruling 2002-51-016 (September 23, 2002); I.R.S. Private Letter Ruling 2002-51-017 (September 23, 2002); I.R.S. Private Letter Ruling 2002-51-018 (September 23, 2002); I.R.S. Private Letter Ruling 1999-52-086 (September 30, 1999).

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general corporate tax principles and has non-tax justifications as well. A general principle of U.S. income tax law is that pass-through entities pass through the underlying character of income,[41] whereas entities treated as corporations block the underlying character of income.[42] In adhering to this principle for debt-financed UBIT, current tax law merely treats income subject to debt-financed UBIT the way it does other income, whether flowing to a for-profit or a nonprofit entity. Moreover, there are a number of non-tax business reasons why a nonprofit might want to use a foreign blocker corporation to hold an offshore investment. A blocker corporation might provide the nonprofit with greater flexibility in disposing of the investment, since there are sometimes restrictions on the transferability of interests in an investment fund.[43] For instance, the consent of an investment fund's general partner might be required to transfer a nonprofit's interests in an investment fund, but not the stock of a blocker corporation through which a nonprofit owns interests in the investment fund.[44] A blocker corporation also provides an additional layer of liability and might also improve the efficiency of a nonprofit's management of its investments.[45]

On the other hand, the non-tax reasons for using foreign blocker corporations, which "almost always exist to some extent[,] … often pale in comparison to the tax benefit" of avoiding UBIT.[46] To assess whether the use of foreign blocker corporations to avoid UBIT is proper, then, one needs to go beyond both general corporate tax principles and the identification of a business purpose. One must also look at the purpose of the debt-financed UBIT. What did Congress mean to accomplish with the debt-financed UBIT? And does the use of foreign blocker corporations undermine its purpose?

4.1 Primary Purpose of the Debt-Financed UBIT Rules

As the legislative history makes clear, Congress originally enacted the debt-financed UBIT to prevent abusive sale-leaseback transactions. Prior to 1950, a nonprofit organization's exemption from federal income taxation applied to all

41 I.R.C. § 702(b).
42 *See* William B. Taylor, "'Blockers,' 'Stoppers,' and the Entity Classification Rules," *Tax Lawyer* 64 (2011): 1 (detailing the numerous contexts in which blockers can be used).
43 *E.g.*, I.R.S. Private Letter Ruling 2002-51-016 (September 23, 2002).
44 *Id.*
45 *Id.*
46 Miller, *supra* note 3.

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the organization's income dedicated to exempt purposes.[47] A nonprofit that operated one or more for-profit businesses thus did not need to pay any income tax so long as it used the proceeds from its for-profit enterprises to support its exempt purposes. However, in response to concern that this wholesale tax exemption gave nonprofit organizations an unfair advantage over for-profit organizations in business activities unrelated to their exempt purposes and that it facilitated certain types of abusive transactions, Congress in 1950 introduced the UBIT.[48]

Originally, the definition of UBIT excluded "passive" income, except for some rents from property acquired through debt financing.[49] This exception to the passive income exception to UBIT was intended to prevent certain abusive sale-leaseback transactions. In these transactions, a nonprofit would acquire property from a taxable organization, often with the help of debt financing, and then lease the property back to the seller on a long-term basis. The nonprofit would use the rental income from the long-term lease to pay off the debt financing. It got to keep any difference between the two and, after all the debt payments had been made, to secure title to the property. The taxable organization, for its part, got to treat profit from the sale as capital gain and to use the lease payments as business deductions against its taxable income.[50]

Congress thought sale-leasebacks of this sort problematic for three reasons. First, the nonprofit was trading on its tax exemption. In its view, the nonprofit contributed nothing to such sale-leaseback transactions but its tax exemption.[51] Second, Congress feared the erosion of the corporate tax base. Because sale-leaseback transactions of this sort enabled nonprofits to acquire property at little

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47 Henry B. Hansmann, "Unfair Competition and the Unrelated Business Income Tax," *Virginia Law Review* 75 (1989): 605, 608; Suzanne Ross McDowell, "Taxing Leveraged Investments of Charitable Organizations: What Is the Rationale?," *Case Western Reserve Law Review* 39 (1989): 705, 707.

48 H.R. Rep. No. 81–2319, 81st Cong., 2nd Sess., at 38–39 (1950); McDowell, *supra* note 47, at 708.

49 Passive income is income earned from an investment or business in which the earner is not actively involved. Examples include interest, dividends, and certain kinds of rental income.

50 H.R. Rep. No. 81–2319, at 38; McDowell, *supra* note 47, at 709–10.

51 H.R. Rep. No. 81–2319, at 38–39 ("There are three principal objections to the lease-back arrangements where borrowed funds are used. First, the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption, since the only contribution it makes to the sale and lease is its tax exemption. Therefore, it appears reasonable to believe that the only reason why it receives the property at no expenses to itself is the fact that it pays no income tax on the rentals received.").

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risk, Congress was worried that they might come to own the majority of American real estate.[52] Third, Congress feared that, in addition to trading on its exemption, the nonprofit in an abusive sale-leaseback might in effect be selling its exemption. The nonprofit could pay a higher price for the property in question or charge a lower rental price than a similarly situated taxable organization.[53]

This legislative history makes it difficult to argue that the use of foreign blocker corporations to avoid debt-financed UBIT is contrary to the debt-financed UBIT's purposes. Alternative investment funds are very different from the abusive sale-leaseback transactions that the debt-financed UBIT rules were designed to prevent and which, at least in part because taxpayers and tax-exempt organizations found ways around the original rules, Congress in subsequent decades went on to expand.[54] While Congress clearly thought more sweeping rules necessary to combat abusive sale-leasebacks than the ones originally enacted in 1950, it did not go so far as to tax all leveraged investments or even all leveraged sale-leasebacks. The Federal International Revenue Code explicitly excepts specific types of property for "qualified organizations" from the debt-financed UBIT rules.[55] And under Treasury Department regulations, I.R.S. guidance, and judicial case law, nonprofits can make many

52 *Id.* at 39 ("The second objection to the lease-back is that it is altogether conceivable that if its use is not checked, exempt organizations in the not-too-distant future may own the great bulk of the commercial and industrial real estate in the country. This, of course, would lower drastically the rental income included in the corporate and individual income tax bases. The fact that under present law an exempt institution need not use any of its own funds in acquiring property through lease-backs – borrowed funds may represent 100 percent of the purchase price – indicates that there is no limit to the property an exempt institution may acquire in this manner. Such acquisitions are not in any way limited by the funds available for investment on the part of the exempt institution. This explains why particular attention should be given to lease-backs which involve the use of borrowed funds. Where an exempt organization uses its own funds, expansion of its property holdings through the lease-back device must necessarily proceed at a much slower pace.").

53 *Id.* ("A third reason for proposing the taxation of lease-backs is the possibility which exists in each case that the exempt organization has in effect sold part of its exemption. This can occur either by the exempt organization paying a higher price for the property or by charging lower rentals than a taxable business could charge.").

54 Summer A. Lepree, "Taxation of United States Tax-Exempt Entities' Offshore Hedge Fund Investments: Application of the Section 514 Debt-Financed Rules to Leveraged Hedge Funds and Derivatives and the Case for Equalization," *Tax Lawyer* 61 (2008): 807, 820–30; McDowell, *supra* note 47, at 710–23; William H. Weigel, "Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)," *Tax Lawyer* 50 (1997): 625, 642–45.

55 I.R.C. § 514(c)(9).

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other types of leveraged investments without incurring debt-financed UBIT, such as leveraged mutual funds, options, short sales, and equity swaps.[56] From the perspective of economic efficiency, it is problematic that U.S. tax law fails to treat alike economically equivalent leveraged transactions. However, from the perspective of congressional purpose, what this differential treatment suggests is that the purpose of the debt-financed UBIT is quite narrow. The debt-financed UBIT does not aim to regulate nonprofit use of leverage in general, only abusive sale-leaseback transactions.

4.2 Secondary Purposes of the Debt-Financed UBIT Rules

While the primary and original purpose of the debt-financed UBIT was to combat abusive sale-leaseback transactions, it arguably has secondary purposes as well. The most important secondary purpose is improving the public accountability of nonprofits. Another may be raising revenue.

4.2.1 Public Accountability

The legislative history of the Tax Reform Act of 1969, which expanded the scope of the debt-financed UBIT rules, demonstrates that Congress continued to be concerned about abusive sale-leaseback transactions, but also reveals a possible second motivation for more sweeping debt-financed UBIT rules: the concern, articulated by the Treasury Department, that debt financing would enable charities to expand without regard to their level of public support.[57]

> By borrowing, the organization can extend the function of its exemption beyond the protection of income stemming from charitable contributions or membership fees: it can use the exemption to develop funds even where there are no contributions or membership fees.

56 Brunson, *supra* note 33, at 242–44. The Internal Revenue Code itself speaks not of leverage, but rather of "acquisition indebtedness," which it fails to define. I.R.C. § 514. As the common law notion of indebtedness involves borrowing, the courts and I.R.S. have concluded that the debt-financed UBIT does not apply to numerous transactions that do not involve borrowing but do involve leverage. *See* Lepree, *supra* note 54, at 832–39.

57 McDowell, *supra* note 47, at 713 and 726–27; Staff of the H. Comm. on Ways and Means and Staff of the S. Comm. on Finance, 91st Cong., 1st Sess., Tax Reform Studies and Proposals 306–07 (J. Comm. Print 1969) (work of the U.S. Treas. Dep't).

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> Commentators have referred to this activity as "trading upon" or "capitalizing" the tax exemption. The organization which makes such use of its exemption can sever itself from reliance upon contributors or members and eliminate the healthful scrutiny of its purposes and activities which that reliance implies.[58]

In a world with the debt-financed UBIT but without the foreign blocker corporation workaround, nonprofits may well have greater public accountability than in a world without the debt-financed UBIT. By penalizing debt-financed acquisition of investment property, the debt-financed UBIT makes it more difficult for nonprofits to accumulate money and thus probably makes it harder for nonprofits to become independent of public support.[59]

By introducing additional tax reporting requirements, moreover, the debt-financed UBIT makes nonprofit investment and finances more transparent.[60] Form 990-T and its accompanying Schedule E, on which nonprofits report debt-financed UBIT, is a rich source of information concerning a nonprofit's finances, one that since 2006 has been accessible to not only the I.R.S. but also the public.[61] The I.R.S. makes only limited use of the data on these forms: tax auditing and statistical analysis.[62] But these data could conceivably be used for other purposes, for instance, to assess the risk profile of a nonprofit's endowment.[63] Acquisition indebtedness (and leverage in general) is one of the main sources of risk in financial investments. By providing information on acquisition indebtedness (e.g., percentage of the acquisition financed by debt), Form 990-T and Schedule E thus provide the government, the public, and nonprofit boards with an important data point for assessing the risk profile of a nonprofit's investment portfolio.

In a world with both the debt-financed UBIT and the foreign blocker corporation workaround, however, nonprofits may well be less accountable than in

58 *Unrelated Debt-Financed Income of Tax-Exempt Organizations: Hearing Before the House Committee on Ways and Means on H.R. 15,942 and H.R. 15,943*, 89th Cong., 2nd Sess. 21–22 (1966) (statement of Stanley S. Surrey, Assistant Secretary of the Treasury).

59 *Cf*. McDowell, *supra* note 47, at 730–32; Brunson, *supra* note 33, at 254.

60 On the general importance of transparency, see Norman Silber, "Anti-Consultative Trends in Nonprofit Governance," *Oregon Law Review* 86 (2007): 65.

61 Treas. Reg. § 301.6104(d); I.R.S. Notice 2007–45.

62 *See* SOI Tax Stats – What's New, I.R.S. Accessed December 5, 2014. http://www.irs.gov/uac/SOI-Tax-Stats-What's-New.

63 *Cf*. Peter Swords, "The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits," *Tax Lawyer* 51 (1998): 571 (showing how the Form 990 can be used as an accountability tool). There is a considerable body of literature on whether Form 990 does what it should be doing. *E.g.*, Evelyn Brody, "Sunshine and Shadow on Charity Governance: public Disclosure as a Regulatory Tool," *Fla. Tax Rev*. 12 (2012): 183; Rummana Alam, Note, "Not What the Doctor Ordered: Nonprofit Hospitals and the New Corporate Governance Requirements of the Form 990," *University of Illinois Law Review* 2011: 229.

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a world without debt-financed UBIT or in a world where the debt-financed UBIT exists but the foreign blocker corporation workaround does not. First, the disparate treatment of foreign as opposed to domestic blocker corporations incentivizes nonprofits to shift their investments into offshore investment vehicles, i.e., vehicles organized in tax haven jurisdictions. But tax havens generally have laxer laws and oversight than in the United States.[64] Second, by circumventing the debt-financed UBIT, the use of foreign blocker corporations also reduces the amount of information available to the government and the public. The use of foreign blocker corporations does more than lessen the tax that nonprofits must pay; it also decreases the amount and type of information that nonprofits must report.

4.2.2 Raising Revenue

Whatever regulatory purposes they might serve, tax rules generally also have a revenue-raising function. By using foreign blocker corporations to avoid debt-financed UBIT, nonprofits arguably frustrate this latter purpose. The non-public nature of alternative investment funds and nonprofit endowments make concrete figures hard to come by. But it seems clear that nonprofits are currently investing large sums offshore, thereby avoiding taxes on those sums.[65] Blocking foreign blocker corporations would allow the government to recover at least some of this amount.[66]

Legitimate tax avoidance – as opposed to illegal tax evasion – is, by definition, never abusive. As Judge Learned Hand famously noted, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[67]

Individual and for-profit investment in tax havens, however, is problematic because of the great potential for tax evasion. Not only can individuals and for-profits use technical rules to minimize their tax bill, but they can also exploit tax "havens" to avoid paying taxes that they legally owe, most notably by moving money to opaque offshore accounts. U.S. taxpayers are required to

64 The potential problem thus is not foreign investment by nonprofits, but rather nonprofits using offshore rather than domestic vehicles to make these investments.
65 See *supra* text at notes 21–23.
66 It can be anticipated that not all of this sum could be recovered because nonprofits would then shift their investments to untaxed sources, like hedge funds that use short selling.
67 Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

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report their foreign income to the I.R.S. But since governments and financial institutions in many tax haven jurisdictions provide the federal government with little to no information about the financial activities of U.S. taxpayers there, determined taxpayers can nevertheless still keep significant income out of the reach of the I.R.S.[68]

The other main way in which taxpayers can use tax havens to engage in abusive tax avoidance or tax evasion is excessive tax deferral. In general, the Federal Internal Revenue Code allows taxpayers to defer tax on the income earned by a foreign subsidiary.[69] Because of the time value of money, such deferral can result in significant economic benefit.[70] The tax savings can be particularly great when deferral is combined with techniques like transfer pricing to artificially shift profits to tax haven jurisdictions.[71]

Because nonprofits generally do not owe income tax, they have fewer incentives to hide or defer income in tax haven jurisdictions than do individuals and for-profits. Nonprofits use foreign blocker corporations to exploit an exception in the debt-financed UBIT rules, not to hide or defer income. As a tax avoidance technique, then, the use of foreign blocker corporations by nonprofits is unobjectionable. The one possible cause for concern from the revenue perspective is that the use of foreign blocker corporations encourages the offshore financial industry and thus indirectly supports the abuse of tax havens by individuals and for-profits. In and of itself, however, the use of foreign blocker corporations by nonprofits is not abusive.

68 Brunson, *supra* note 33, at 238. To combat such tax evasion, Congress passed the Foreign Account Tax Compliance Act (FATCA) in 2010. Pub. L. No. 111–147, §§ 501, 511–13, 521–22, 124 Stat. 71 (codified as amended at I.R.C. §§ 1471–74 and elsewhere). The law requires foreign financial institutions and non-U.S. non-financial entities to identify and disclose their U.S. account holders or pay a new 30% withholding tax. I.R.C. §§ 1471, 1472. However, as the reporting and withholding requirements have only gone into effect recently, in 2014, it remains to be seen whether the law will prove effective.

69 The main exception is Subpart F income (I.R.C. §§ 951–965). This section of the tax code combats abusive tax deferral techniques by requiring entities to pay current tax on certain types of income earned by corporate subsidiaries even if the subsidiaries do not dividend the income to the parent. On the enactment of Subpart F, see *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* at 1–22, Office of Tax Policy, Department of the Treasury, December 2000.

70 For an illustration, see Brunson, *supra* note 33, at 240–41.

71 *See, e.g.*, Permanent Subcommittee on Investigations, *Exhibit 1a – Subcommittee Memo on Offshore Profit Shifting* 34, May 21, 2013, http://www.hsgac.senate.gov/download/?id = CDE3652B-DA4E-4EE1-B841-AEAD48177DC4 (accessed July 4, 2015) (detailing the ways in which Apple has used transfer pricing and other techniques, together with deferral, to evade billions of dollars in U.S. federal income taxes).

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5 Approaches to Reform

There are two main ways in which the debt-financed UBIT could be reformed.[72] First, Congress could block the use of foreign blockers to avoid debt-financed UBIT, for instance, by treating foreign blocker corporations as domestic corporations subject to U.S. income tax, as proposed in the Stop Tax Haven Abuse Act.[73] If Congress were to take this route, it should seriously consider expanding the debt-financed UBIT rules so that they encompass all forms of leverage, not just those where money has been borrowed. As indicated above, one of the main problems with the current debt-financed UBIT rules is that they do not treat leveraged transactions that are economically equivalent the same.

Normally, the disparate tax treatment of economically equivalent transactions results in economic inefficiencies and distorts the allocation of capital. Because foreign blocker corporations allow nonprofits to avoid debt-financed UBIT, however, the limitation of debt-financed UBIT to transactions involving borrowing probably does not significantly distort decisions concerning what form of leveraged transaction to engage in. But this situation would probably change if Congress were to block the use of foreign blockers without expanding the reach of the debt-financed UBIT rules. In this latter scenario, borrowing to acquire investment property would become significantly tax disadvantaged relative to other forms of leveraged investment. The main consequence of this differential tax on borrowing might be a distortion of the types of alternative investments that nonprofits invest in: options, swaps, and other complex financial instruments would be favored over hedge funds and private equity funds.[74] Nonprofits might end up with even riskier portfolios than the ones they otherwise would like to have maintained, with even greater losses and damage in the next financial crisis.[75]

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72 *Cf*. Cauble, *supra* note 39 (proposing a passive partnership exception to the debt-financed UBIT rules); Brunson, *supra* note 33 (proposing the repeal of the debt-financed UBIT rules and the expansion of the reportable transaction regime).

73 S. 506, 111th Cong. (1st Sess. 2009): H.R. 1265, 111th Cong. (1st Sess. 2009).

74 *Id*. at 843 ("Tax-exempts might simply stop investing so much in hedge funds and start investing in options and swaps instead. An even more likely consequence is that hedge fund managers will respond to developments in the tax law by revising their investment strategies to accommodate continued investment by tax-exempts.").

75 *See, e.g.*, James Panero, *The Culture Crash*, Forbes, July 20, 2009, http://www.forbes.com/2009/07/19/arts-museums-philanthropy-opinions-contributors-economic-crisis.html (accessed July 4, 2015); Steven I. Weiss, *How to Lose $1 Billion: Yeshiva University Blows Its Future on Loser Hedge Funds*, June 17, 2014, http://www.takepart.com/feature/2014/06/17/yeshiva-university-loses-endowment-hedge-funds (accessed July 4, 2015).

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An alternative approach to reforming the debt-financed UBIT would be to have Congress repeal the debt-financed UBIT rules completely. Without the debt-financed UBIT, nonprofits could achieve the same returns with onshore funds that they currently do investing through offshore funds. To protect against abusive sale-leaseback transactions and other abusive transactions involving nonprofits, Congress could use more narrowly tailored rules.[76]

The principal collateral negative consequence to the second approach would be an overall reduction in the amount of information available to regulators and the public. In the absence of the debt-financed UBIT, the reporting of leverage activities would be even weaker than it is now – and as currently constructed the transparency mandated by the rules has been, in the opinion of the authors, inadequate.

Thus, for example, in the years leading up to the financial crisis, many nonprofits copied the Yale model of endowment investing: investing through a diversified portfolio of equity-like assets, particularly illiquid alternative investments such as hedge funds, private equity, and real estate.[77] These endowments performed well during the bubble preceding the financial crisis, but suffered terribly when the financial crisis hit. Not only did such endowments experience the normal declines in value that occur during market downturns, but, because of the illiquid nature of many alternative investments, they often experienced great liquidity problems as well.[78] Some nonprofits, like Yale and Brown, have just about recovered from the financial crisis.[79] Others, like Yeshiva University and the New York City Opera, suffered grave harm.[80] In the hands of a disinterested and financially interested board of directors, greater transparency in connection with the risk profile of endowment portfolio might have mitigated or prevented these losses.

If Congress adopts this second option and repeals the debt-financed UBIT, it could address the transparency concern by maintaining the current reporting

76 *See* Lepree, *supra* note 54, at 848–50 (providing concrete suggestions).

77 On the Yale model of investing, see generally David F. Swensen, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* (New York: Free Press, 2000).

78 *See, e.g.*, "Further Financial Fallout," *Harvard Magazine*, January–February 2010, http://harvardmagazine.com/2010/01/harvard-2009-financial-losses-grow (accessed July 4, 2015) (describing the liquidity pressures that the financial crisis placed on Harvard's endowment, which were exacerbated by its many illiquid investments).

79 Lauren Streib, *Harvard Stands Out in Failing to Reach Pre-crisis Endowment Peak*, Bloomberg, October 7, 2014, http://www.bloomberg.com/news/2014-10-07/harvard-stands-out-in-failing-to-reach-pre-crisis-endowment-peak.html (accessed July 4, 2015).

80 Panero, *supra* note 75; Weiss, *supra* note 75.

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requirements or by strengthening them so that they apply to all leveraged investments. Regulators and the public would then benefit from knowing not just about debt-financed investments, but leveraged investments more generally, and would gain access to this information not only for onshore investments, but also for offshore ones where a foreign blocker corporation has been interposed. The debt-financed UBIT may not work particularly well as a tax, but in our view it has potential as a reporting and accountability tool.

6 Conclusion

U.S. nonprofits create foreign legal entities not only to support international mission-related activities, but also to avoid incurring debt-financed UBIT. As a tax avoidance technique, the use of foreign blocker corporations is unobjectionable and represents navigation rather than gaming of the current legal and tax regime. Allowing the use of foreign blocker corporations to avoid debt-financed UBIT, however, distorts the location of nonprofit investments, resulting in their being channeled offshore, and also makes nonprofit investments less transparent. Congress could address these issues in two main ways. If the accrual of tax revenue is a principal concern, Congress could block the use of blocker corporations and expand the scope of the debt-financed UBIT rules to encompass all forms of leveraged investments. Otherwise, if the goal is greater efficiency in the allocation of nonprofit investments, Congress might repeal the debt-financed UBIT entirely, while retaining and even expanding reporting requirements for leveraged investments.

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