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REPATRIATING TAX-EXEMPT INVESTMENTS: TAX HAVENS, BLOCKER CORPORATIONS, AND UNRELATED DEBT-FINANCED INCOME

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ABSTRACT—When a tax-exempt entity is both able and willing to lend its exemption to other taxpayers, tax-averse parties line up to take advantage of its largesse (and, in the process, reduce their own tax bill). Congress, eager to prevent such abuse of the exemption, decided that, in some circumstances, it would tax entities that would otherwise be exempt from taxation. In this Article, I show that Congress’s response to such “lending” has failed to solve the problem and, in fact, is harmful to the tax system and to tax-exempt entities. To address this problem, this Article proposes a new way to prevent such lending—one that builds upon existing law—in order to combat the abuses perpetrated through tax-exempt entities. Congress should repeal the unrelated debt-financed income rules, which experience has shown are ineffective and harmful. This repeal would end the distortions that tax-exempt entities currently face. At the same time, in order to prevent tax-exempt entities from lending their exemptions to taxpayers, Congress should expand the tax shelter rules to capture these abusive transactions.

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INTRODUCTION

When a tax-exempt entity is both able and willing to lend its exemption to other taxpayers, tax-averse parties line up to take advantage of its largess (and, in the process, reduce their own tax bill). Congress, eager to prevent such abuse of the exemption, decided that, in some circumstances, it would tax entities that would otherwise be exempt from taxation. In this Article, I show that Congress’s response to such “lending” has failed to solve the problem and, in fact, is harmful to tax-exempt entities. I propose a new way—one that builds upon existing law—to combat the abuses perpetrated through tax-exempt entities.

It was inevitable that taxpayers would exploit the exemption granted to certain charitable entities. The Internal Revenue Code is a patchwork of

provisions enacted at different times and for different purposes.¹ Congress uses the tax law both to raise revenue² and for unrelated purposes such as “encouraging particular types of investment, supplying economic relief to targeted groups of taxpayers . . . and regulating the economy, not to mention enhancing the political power of politicians among their constituents.”³ Such a broad array of goals inexorably leads to a complex and confusing regime,⁴ and the tax exemption provides one of the many cracks exploited by savvy taxpayers.⁵

In the United States, the difference between what taxpayers owe in any given year and what they pay on time—the tax gap—is about \$345 billion.⁶ An estimated \$40 billion to \$70 billion of that tax gap results from U.S. taxpayers using tax havens to whittle down their tax bills.⁷ Congress has worked for years to narrow the tax gap.⁸

¹ See, e.g., *Hous. Textile Co. v. Comm’r*, 173 F.2d 464, 464 (5th Cir. 1949) (“This petition brings up for solution one of those difficult jigsaw tax law puzzles all too common in the present deplorable crazy quilt patchwork state of the Internal Revenue laws.”).

² Richard A. Westin & Sanford E. Gaines, *The Relationship of Federal Income Taxes to Toxic Wastes: A Selective Study*, 16 B.C. ENVTL. AFF. L. REV. 753, 760 (1989) (“[T]he purpose of the Code is to raise revenue . . .”). But see Kimberly A. Pace, *The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden for Corporate Misconduct?*, 47 ALA. L. REV. 825, 865 (1996) (“[I]f the sole purpose of the tax code were to raise revenue, the Code would be much shorter and much simpler.”).

³ Andrew D. Cuccia & Gregory A. Carnes, *Simplifying the Personal Income Tax*, 55 TAX NOTES 1817, 1817 (1992).

⁴ See, e.g., Learned Hand, *Thomas Walter Swan*, 57 YALE L.J. 167, 169 (1947) (“[T]he words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession . . . leav[ing] in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.”).

⁵ See, e.g., Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 383 (2002) (“[E]ven if an anti-abuse rule were adopted, ongoing amendments to the Code or regulations may continue to be necessary to close specific loopholes.”).

⁶ See, e.g., OFFICE OF TAX POLICY, U.S. DEP’T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5 (2006), available at <http://www.treasury.gov/press-center/press-releases/Documents/optaxgapstrategy%20final.pdf>.

⁷ In 2002, an IRS consultant estimated that the United States lost \$70 billion annually in taxes to offshore tax evasion. See Martin A. Sullivan, *U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, 103 TAX NOTES 956, 958 (2004). More recently, the Treasury Inspector General for Tax Administration estimated that the total international tax gap was between \$40 billion and \$123 billion annually, with between \$40 billion and \$70 billion of that tax gap resulting from tax haven activity. OFFICE OF INSPECTIONS AND EVALUATIONS, TREASURY INSPECTOR GEN. FOR TAX ADMIN., A COMBINATION OF LEGISLATIVE ACTIONS AND INCREASED IRS CAPABILITY AND CAPACITY ARE REQUIRED TO REDUCE THE MULTI-BILLION DOLLAR U.S. INTERNATIONAL TAX GAP 4 (2009), available at <http://www.treasury.gov/tigta/iereports/2009reports/2009IER001fr.pdf> [hereinafter TREASURY, TAX GAP].

⁸ Congress’s attempt to prevent tax haven abuse alone involves several separate regimes. In 1962, it enacted the subpart F rules to reduce the benefits available by investing in tax haven corporations. See Reuven S. Avi-Yonah, *Tax Competition and Multinational Competitiveness: The New Balance of*

In Congress's attempts to narrow the tax gap by preventing taxpayers from hiding their money in tax havens, it has inadvertently pushed tax-exempt entities to do the opposite. As a result of the laws enacted to prevent tax-exempt entities from lending their exemption to tax evaders (i.e., the unrelated debt-financed income rules), tax-exempt entities cannot invest in U.S. hedge funds. Instead, tax-exempt entities that want hedge fund returns must invest through corporations organized in tax havens.⁹ And these investments are far from negligible: as many as one-third of all hedge fund assets may be attributable to tax-exempt investors, including endowments and pension funds.¹⁰

Even if the unrelated debt-financed income rules did not force tax-exempt entities to shift their investments from U.S. to tax haven hedge funds, the rules are bad tax policy, failing to prevent even abusive transactions of the type that they were passed to prevent, while at the same time distorting tax-exempt entities' legitimate economic decisions.

There is a simple solution to the problems that the unrelated debt-financed income rules present: Congress should repeal them. Tax-exempt entities would no longer face distortions of their investment decisions. At the same time, in order to prevent tax-exempt entities from lending their exemption, Congress or the Treasury Department should expand the tax shelter rules to capture these abusive transactions.¹¹

Subpart F—Review of the NFTC Foreign Income Project, 18 TAX NOTES INT'L 1575, 1575 (1999). For a brief overview of the subpart F regime, see *infra* note 94. Later, Congress supplemented the subpart F rules with another set of rules aimed at reducing the ability of U.S. taxpayers to exploit tax havens to reduce their taxes, called the passive foreign investment company (PFIC) regime. See, e.g., David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1382 (2001). For a brief overview of the PFIC rules, see *infra* note 94. More recently, Congress attempted to discourage U.S. corporations from moving their profits to tax havens by enacting "anti-inversion" legislation. See Lee A. Sheppard, *Taking the Good with the Bad in the Anti-Inversion Rule*, 126 TAX NOTES 913, 913 (2010). And on July 12, 2011, Senator Carl Levin introduced, for the fifth time, legislation that would treat certain foreign corporations as domestic corporations for tax purposes. Stop Tax Haven Abuse Act, S. 1346, 112th Cong. § 103 (2011); see also Meg Shreve, *Levin Tweaks, Reintroduces Bill Targeting Offshore Tax Shelters*, 132 TAX NOTES 230, 230 (2011) (stating that the Tax Haven Abuse Act resulted from "10 years of committee hearings and investigative work"). Still, it is not currently clear whether Congress will eventually pass the Stop Tax Haven Abuse Act. Even if the Act never becomes law, however, Congress will almost certainly make another move toward collecting the revenue it loses to tax havens eventually.

⁹ See *infra* Part I.C.

¹⁰ Martin A. Sullivan, *Offshore Explorations: Caribbean Hedge Funds, Part 2*, 118 TAX NOTES 255, 258 (2008). Because hedge funds are lightly regulated and most data about hedge funds come from voluntary surveys, it is not possible to know the identities of hedge fund investors with any certainty. Still, survey data paint a general portrait of the body of hedge fund investors. *Id.* at 255.

¹¹ The centerpiece of the tax shelter rules is the requirement that participants disclose "reportable transaction[s]" in which they participate. I.R.C. § 6111(a) (2006). Titled "Disclosure of reportable transactions," prior to 2004, the name of Section 6111 was "Registration of tax shelters." See, e.g., I.R.C. § 6111 (2000); American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 815(a), 118 Stat. 1418, 1581 (2004) (amending I.R.C. § 6111 (2000)). By expanding the tax shelter rules, the IRS would continue to have the ability to penalize parties engaging in abusive transactions.

This Article begins in Part I by discussing situations in which Congress has determined it is appropriate for tax-exempt entities to pay taxes. It will look at the reasons underlying Congress's departure from its normal treatment of those organizations to which it has granted an exemption. It will also discuss how hedge funds have used tax havens to accommodate the special needs of their tax-exempt investors. Part II will then discuss how U.S. taxpayers can use tax havens to avoid paying taxes and why tax-exempt entities' use of tax havens is qualitatively different and not abusive.

Part III will explore the purposes for which Congress enacted the unrelated debt-financed income rules. It will evaluate their effectiveness at preventing the abuses that Congress saw as well as the unintended distortions they introduce into tax-exempt entities' decisionmaking processes. Finally, Part IV will propose that the unrelated debt-financed income regime be repealed and that abusive behavior by tax-exempt entities be policed instead by the reportable transaction rules.

I. TAXING SELECTED INCOME EARNED BY TAX-EXEMPT ENTITIES

Qualifying tax-exempt entities generally find themselves outside of the scope of the federal income tax.¹² Charitable organizations have been continuously exempt from taxation since the enactment of the first corporate income tax¹³ in spite of commentators' struggles to articulate a comprehensive justification for exempting certain organizations from tax.¹⁴

Even charitable organizations must occasionally pay taxes, though. An otherwise tax-exempt entity owes taxes on its "unrelated business taxable income" (UBTI) as if it were an ordinary corporation.¹⁵ UBTI generally consists of active income earned by a tax-exempt entity from carrying on a

¹² I.R.C. § 501(a) (2006).

¹³ Leo L. Schmolka, *Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism*, 40 TAX L. REV. 1, 5 (1984) ("Since the inception of the modern income tax in 1913, the Code has reflected Congress' purpose of fostering a broad array of charitable activities by exempting them from federal income tax." (footnote omitted)). Even before then, charitable corporations were exempt from tax under the Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. See Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 426 n.16 (1998). However, the Supreme Court declared the Revenue Act of 1894 unconstitutional in 1895. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 586 (1895), *modified*, 158 U.S. 601 (1895).

¹⁴ Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1381 (1991) ("Due primarily to the vast array of activities to which the exemption has been applied, it has defied all past attempts to formulate a synthesizing concept of charitable."). Notwithstanding the difficulty in formulating a precise justification for the exemption of certain organizations from the federal income tax, this Article will assume both that the exemption serves a public purpose and that it will continue, albeit with some marginal periodical changes. See, e.g., Evelyn A. Lewis, *Charitable Waste: Consideration of a "Waste Not, Want Not" Tax*, 30 VA. TAX REV. 39, 48 n.30 (2010).

¹⁵ I.R.C. § 511(a).

trade or business.¹⁶ It also includes income earned by a tax-exempt entity from an investment bought using borrowed money.¹⁷ This subset of UBTI is known as “unrelated debt-financed income.”¹⁸ The UBTI and unrelated debt-financed income rules effectively limit the types of investments that tax-exempt entities are willing to make as well as the manner in which tax-exempt entities can make the investments.

A. UBTI Generally

Prior to the enactment of the UBTI rules in 1950, a for-profit business could escape taxation if it was wholly owned by a tax-exempt entity and its income was used exclusively to support the owner’s exempt purposes.¹⁹ That changed in 1950 when, in response to the perceived unfair advantages these businesses could enjoy, Congress enacted the “unrelated business income tax.”²⁰

The Mueller Macaroni Company—the “prototypical and most familiar unrelated business”²¹—illustrates Congress’s motive for enacting the unrelated business income tax. In the 1940s, a group of benefactors donated the stock of C.F. Mueller Company, then the country’s largest manufacturer of macaroni, to New York University (NYU).²² Because Mueller was wholly owned by NYU, a tax-exempt organization, its profits were not taxable,²³ in spite of the fact that making macaroni was unrelated to NYU’s charitable purpose. Congress’s worries about “the effect these tax-free enterprises had on their competitors resulted in the passage of” the UBTI provisions.²⁴ After 1950, NYU’s profits from making macaroni were taxable as UBTI.

But unrelated business encompasses more than just tax-exempt entities running factories. Income earned by a tax-exempt entity is UBTI if it meets three criteria: (1) it must be income from a trade or business, (2) the trade or business must be “regularly carried on” by the tax-exempt organization, and (3) the trade or business must not be “substantially related” to the organization’s performance of its tax-exempt purpose.²⁵

¹⁶ *Id.* §§ 512(a), 513(a).

¹⁷ *Id.* § 514(a).

¹⁸ *Id.*

¹⁹ Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 608 (1989).

²⁰ Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 817–18 (1989) (“A conspicuous example was the passage of the unrelated business income tax in 1950, a provision that effectively withdraws corporate income tax exemption from the commercial activities of all nonprofits, including charities.”).

²¹ Hansmann, *supra* note 19, at 608.

²² Diane L. Fahey, *Taxing Nonprofits out of Business*, 62 WASH. & LEE L. REV. 547, 549 (2005).

²³ *C. F. Mueller Co. v. Comm’r*, 190 F.2d 120, 123 (3d Cir. 1951).

²⁴ *C. F. Mueller Co. v. Comm’r*, 479 F.2d 678, 681 (3d Cir. 1973).

²⁵ Treas. Reg. § 1.513-1(a) (as amended in 1983).

For example, a portion of the National Collegiate Athletic Association's (NCAA) revenue on its annual Men's Division I Basketball Tournament comes from selling advertising in the Tournament programs.²⁶ The IRS claimed that this advertising revenue was UBTI and that the NCAA owed taxes on that portion of its revenue. The NCAA conceded that the sale of advertising space was a trade or business and that it was not substantially related to the NCAA's exempt purpose, but argued that its selling advertising in tournament programs was not regular enough to meet the second criterion of the test.²⁷ The Tenth Circuit agreed with the NCAA.²⁸ The court buttressed its conclusion by noting that the Treasury Regulations, in defining "regularly carried on," state that the test should be applied in light of the UBTI's purpose of preventing unfair competition with for-profit businesses.²⁹ The court decided that although the NCAA's programs solicited the same advertisers as, for example, *Sports Illustrated*, the NCAA's once-a-year publication was too infrequent to actually compete for advertisers with such magazines.³⁰ Treating such income as UBTI "therefore would not further the statutory purpose."³¹

The results would have been different, however, if the NCAA had been publishing its programs monthly. The American College of Physicians, a tax-exempt organization, published *Annals of Internal Medicine*, a monthly medical journal.³² The American College of Physicians screened the advertisements for accuracy and relevance³³ but sold the advertising space at rates competitive with the rates charged by other medical journals.³⁴ The government argued that revenue from advertising in a journal published by a tax-exempt entity was per se UBTI, based in part on legislative statements indicating that failing to treat such revenue as UBTI would create unfair competition.³⁵ While the Supreme Court refused to find a per se rule, it did hold that the revenue constituted UBTI.³⁶ The Supreme Court did not address whether *Annals of Internal Medicine* had an unfair competitive advantage in competing with other medical journals for advertisers, but the regularity of its publication suggests that treating it as UBTI would further the legislative purpose in enacting UBTI.

²⁶ NCAA v. Comm'r, 914 F.2d 1417, 1420 (10th Cir. 1990).

²⁷ *Id.* at 1421–22.

²⁸ *Id.* at 1424.

²⁹ *Id.*; see also Treas. Reg. § 1.513-1(c)(1) (as amended in 1983).

³⁰ NCAA, 914 F.2d at 1425.

³¹ *Id.*

³² United States v. Am. Coll. of Physicians, 475 U.S. 834, 836 (1986).

³³ *Id.*

³⁴ Am. Coll. of Physicians v. United States, 3 Cl. Ct. 531, 533 (Cl. Ct. 1983), *rev'd*, 743 F.2d 1570 (Fed. Cir. 1984), *rev'd*, 475 U.S. 834 (1986).

³⁵ 475 U.S. at 842–43.

³⁶ *Id.* at 850.

Traditionally, commentators justify taxing tax-exempt entities on their UBTI because such unrelated business activities create unfair competition with for-profit entities.³⁷ This unfair advantage has two parts: First, because tax-exempt entities do not pay taxes, they can charge lower prices than their for-profit competitors and still earn the same return.³⁸ Second, because they can accumulate earnings more quickly than their for-profit competitors, tax-exempt entities can grow faster and have a lower risk of bankruptcy.³⁹

In addition, commentators argue that it is necessary to tax tax-exempt entities on their active income in order to protect the corporate tax base. If the unfair competition were to give tax-exempt entities a significant advantage over for-profit entities, tax-exempt entities would—the argument goes—eventually be able to purchase a large portion of their competitors or drive them into bankruptcy.⁴⁰ As a result, as taxable businesses disappeared and tax-exempt entities became responsible for a larger portion of business activities, the government would collect less revenue.

B. *Unrelated Debt-Financed Income*

Included under the UBTI umbrella is unrelated debt-financed income.⁴¹ The unrelated debt-financed income rules say that if a tax-exempt entity borrows money and uses that money to purchase an income-producing asset, a percentage of that income will be taxable as UBTI.⁴² Under the unrelated debt-financed income rules, income from a passive activity—one clearly not derived from a trade or business such as dividends earned from securities in an investment portfolio—can be transformed into UBTI if the tax-exempt entity borrows money in order to make the purchase.

Debt-financed passive income does not organically fit in the world of UBTI. When Congress enacted the original UBTI rules, it deliberately exempted passive income, viewing passive income both as a traditional activity of tax-exempt entities and as unlikely to result in unfair competition.⁴³ Why, then, would borrowing money transform passive

³⁷ Hansmann, *supra* note 19, at 605 (“One key dispute over the nonprofits’ exemption privilege centers on their unrelated business activities—that is, profit-making activities that a tax-exempt nonprofit corporation undertakes primarily as a source of income and that are not otherwise related to the principal purposes for which the nonprofit was formed and granted tax exemption.”).

³⁸ See Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1023 (1982).

³⁹ See *id.*

⁴⁰ See Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1491 (2005).

⁴¹ I.R.C. § 514(a) (2006).

⁴² *Id.*

⁴³ See Stone, *supra* note 40, at 1501–02. Arguing against this initial exemption, Professor Stone contends that allowing tax-exempt entities to earn passive income tax-free does, in fact, create unfair competition with taxable investors. *Id.* at 1497. He argues that unfair competition concerns did not actually underlie the enactment of UBTI; rather, Congress was using the UBTI to encourage tax-exempt

investment income into active trade or business income? Clearly, it would not.

But the unrelated debt-financed income rules were meant to prevent a different set of abusive behavior than were the UBTI rules: where the UBTI rules were enacted in reaction to the specter of unfair competition, the unrelated debt-financed income rules were passed in reaction to abusive transactions facilitated by an entity's tax exemption.⁴⁴ Although the original incarnation of UBTI generally excluded passive income, it did include "certain rents on property acquired with borrowed funds."⁴⁵ In including these specific rents in UBTI, Congress intended to prevent certain tax-motivated sale-leaseback transactions.

In an offending sale-leaseback transaction, a tax-exempt entity would simultaneously purchase property (generally real estate) from a taxable person and lease it back to the seller.⁴⁶ The seller-lessee would treat any gain on the sale of property as a capital gain, taxable at a lower rate than ordinary income, while continuing to use the property in its business.⁴⁷ In addition, the seller-lessee could deduct its rental payments.⁴⁸ By entering a sale-leaseback, a seller-lessee could significantly reduce her taxable income.⁴⁹

Sale-leasebacks would not be a problem for tax purposes if the purchaser-lessor were taxable. In general, however, a taxable entity would be unwilling to facilitate a sale-leaseback transaction because the rental payments, deductible to the seller-lessee, would constitute taxable income to the purchaser-lessor.⁵⁰ A tax-exempt entity, however, is indifferent to the

entities to change their investment strategies from "politically embarrassing active investments . . . into passive investments more consonant with the symbolic meaning that sustains the charitable exemption." *Id.* at 1547.

⁴⁴ See H.R. REP. NO. 81-2319, at 38-39 (1950) (listing three reasons that sale-leaseback transactions involving tax-exempt entities are suspect).

⁴⁵ Suzanne Ross McDowell, *Taxing Leveraged Investments of Charitable Organizations: What is the Rationale?*, 39 CASE W. RES. L. REV. 705, 709 (1989).

⁴⁶ William L. Cary, *Sale and Lease-Back of Corporate Property*, 27 HARV. BUS. REV. 151, 151 (1949).

⁴⁷ McDowell, *supra* note 45, at 709. In some cases, the tax result was even better: if the property had depreciated, the seller could realize a loss on the property without actually disposing of it. Cary, *supra* note 46, at 160-61.

⁴⁸ Cary, *supra* note 46, at 159.

⁴⁹ Economically, deducting the rental payments allowed the seller-lessee to depreciate the property for tax purposes, which was advantageous especially where the property was land or had buildings for which little depreciation had been permitted. See William L. Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1, 18 (1948).

⁵⁰ A sale-leaseback transaction does not actually require a tax-exempt facilitation party; anybody who is tax-indifferent would do. Tax-indifferent parties include tax-exempt entities but also include, for example, corporations with tax loss carryforwards that cannot be used before the carryforwards expire, as well as foreign persons not subject to taxation in the United States. Shu-Yi Oei, *Beyond Economic Substance: Interrogating the Full Impacts of Third-Party Relationships in Tax Shelter Cases*, 13 U. PA.

receipt of taxable income. Moreover, the tax-exempt purchaser–lessor faces very little risk: it borrowed the majority of the purchase price and repaid its debt, plus interest, out of the rental income it received from the seller–lessee.⁵¹ And in return for its facilitating the sale–leaseback, the tax-exempt entity keeps the amount of rental payments it receives in excess of its payments on the debt.⁵²

A sale–leaseback transaction does not create unfair competition with taxable entities any more than any other type of rent would. Instead, sale–leaseback transactions presented a problem separate and distinct from the problem the UBTI regime had been enacted to prevent. Because sale–leaseback transactions reduced the net amount of tax paid, they threatened the corporate tax base.⁵³ But while the potential harm differed from the harm targeted by the unrelated business income tax, the transactions targeted by both the UBTI and the unrelated debt-financed income rules involved tax-exempt entities. Thus, presumably, Congress decided to attack both problems using the unrelated business income tax.⁵⁴

In order to prevent abusive sale–leaseback transactions, Congress included a portion of income earned on a “supplement U” lease within the definition of UBTI.⁵⁵ A supplement U lease was defined as a lease of real property with a term of more than five years where the tax-exempt entity

J. BUS. L. 383, 384–85 (2011) (“Shelter transactions represent instances of exceptionally aggressive relationship formation, and in many shelter transactions one sees taxpayers purposefully creating and entering into contracts and relationships with tax-exempt entities, tax-indifferent foreign entities, insurance companies, banks, and other entities in order to generate favorable tax consequences.”).

⁵¹ See McDowell, *supra* note 45, at 709. Land cannot be depreciated for tax purposes, so a sale–leaseback of land created depreciation out of whole cloth. Moreover, even if the property were a building, as long as a relatively small amount of depreciation had been permitted on the building, the deductible rental payments acted as accelerated depreciation. See Cary, *supra* note 49, at 18.

⁵² See Cary, *supra* note 46, at 154. Although the slice of rental payments that the tax-exempt entity kept was small as compared with the total size of the transaction, it generally provided a high rate of return on the tax-exempt entity’s actual unlevered investment. For example, in 1945, Union College purchased property from Allied Stores Corporation for \$16,150,000. Cary, *supra* note 49, at 3. Of that amount, Union College borrowed \$16 million, meaning it only invested \$150,000 of its own money. *Id.* at 4. Its return (i.e., the margin between the rent it received from Allied Stores and the amount it paid to service its debt) would therefore be a return on a \$150,000 investment, not a \$16 million investment. Even a small margin would “represent an extraordinarily high percentage return upon the nominal outlay.” Cary, *supra* note 46, at 154. Moreover, at the end of the thirty-year term of the lease, Union College would own the property outright. *Id.*

⁵³ See, e.g., Emily Cauble, *Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities*, 29 VA. TAX REV. 695, 711 (2010) (“Other possible objectives of imposing the UBIT on non-debt-financed income include . . . preventing erosion of the corporate tax base . . .”).

⁵⁴ See Stone, *supra* note 40, at 1520 (“Given the very real threat to federal tax revenues represented by leasebacks and bootstraps, it is tempting to dismiss the anomalies of Congress’ unfair competition rhetoric and conclude that Congress and the Treasury acted against ‘unfair competition’ in 1950 . . . because they were really trying to shut down tax avoidance schemes.”).

⁵⁵ Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 949 (amending I.R.C. § 422(a)(4)).

had borrowed money to acquire the real property.⁵⁶ In spite of Congress's enactment of these rules, tax-exempt entities "continued to enter sale and lease-back transactions."⁵⁷ They just changed the form by including a third party or leasing the assets for a five-year term.⁵⁸ Although the IRS tried administratively to extend the supplement U lease to the new transactions,⁵⁹ the Supreme Court held that Congress had considered the abusive transactions and had responded "with precise provisions of narrow application."⁶⁰ Because the new sale-leaseback transactions were outside of the scope of the provisions enacted by Congress, the Supreme Court determined that they were not affected by the provisions from 1950.⁶¹

Because of the Supreme Court's decision and tax-exempt entities' continuing ability to use their exemptions in ways Congress did not intend, Congress, in 1969, expanded the reach of the unrelated business income tax.⁶² It enacted the unrelated debt-financed income rules, imposing a tax not only on tax-exempt entities' proceeds from sale-leaseback transactions, but also on all of a tax-exempt entity's income related to borrowed money.

C. Structuring Hedge Funds to Accommodate Tax-Exempt Investors

As a result of the unrelated debt-financed income rules, tax-exempt entities that invest in hedge funds invest almost exclusively in offshore hedge funds, which are generally organized as corporations in a tax haven jurisdiction.⁶³ These offshore hedge funds are referred to as "blocker" corporations.⁶⁴ In order to understand why tax-exempt entities would invest in tax haven hedge funds, it is necessary to take a short discursion through the structure of hedge funds and other private investment funds.

⁵⁶ *Id.* § 301(a), 64 Stat. at 950–52 (amending I.R.C. § 423).

⁵⁷ McDowell, *supra* note 45, at 710.

⁵⁸ *Id.* at 710–11.

⁵⁹ Rev. Rul. 54-420, 1954-2 C.B. 128, 128–30.

⁶⁰ *Comm'r v. Brown*, 380 U.S. 563, 579 (1965).

⁶¹ *Id.*

⁶² See STAFF OF H.R. COMM. ON WAYS & MEANS & S. COMM. ON FIN., 91ST CONG., TAX REFORM STUDIES AND PROPOSALS 26 (Comm. Print 1969) [hereinafter TAX REFORM STUDIES].

⁶³ See, e.g., Sullivan, *supra* note 10, at 258 ("And so tax-exempts invest almost exclusively in offshore funds.").

⁶⁴ See, e.g., Calvin H. Johnson, *Why Do Venture Capital Funds Burn Research and Development Deductions?*, 29 VA. TAX REV. 29, 52 (2009) ("Both foreign and U.S. tax-exempt institutions demand covenants that give them no taxable business income. They also ask for blocker corporations between the business and the investor to prevent their seeing any taxable income."); Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1077–78 n.16 (2008) ("If necessary, the tax-exempt organization can use an offshore 'blocker' corporation in a no- or low-tax jurisdiction . . ."); Willard B. Taylor, "Blockers," *Stoppers*, and the *Entity Classification Rules*, 64 TAX LAW. 1, 5 (2010) ("The most frequent use of the terms 'blockers' or 'stoppers' are for investments in intermediate entities by tax-exempt organizations . . .").

Private investment funds such as hedge funds are “actively managed investments that pool investors’ capital in order to acquire, own, and trade one or more of securities, commodities, and financial products.”⁶⁵ Hedge funds and other investment funds are generally structured as pass-through entities for tax purposes.⁶⁶ As pass-through entities, the hedge funds themselves are not subject to tax.⁶⁷ Instead, investors pay taxes on their share of the fund’s income as if the investors had earned that income directly.⁶⁸ Structuring the fund as a pass-through entity thus prevents investors’ returns from being taxed twice: first when earned by the hedge fund and then a second time when distributed to the investor.⁶⁹

Although structuring investment funds as pass-through entities reduces taxable investors’ taxes, this pass-through structure presents significant problems to potential tax-exempt investors. Private investment funds face no legal restrictions on their use of borrowed money (i.e., leverage),⁷⁰ and their investment strategy often involves borrowing in order to, among other things, increase their return on investment.⁷¹ Under the unrelated business income tax, tax-exempt entities are treated as if they had directly earned not only the income and losses of a pass-through entity in which they invest, but also any UBTI (including unrelated debt-financed income) earned by that pass-through entity.⁷² As such, if a tax-exempt entity invests in a pass-through entity, such as a hedge fund, and the hedge fund borrows money to make investments, a portion of the tax-exempt entity’s income from the hedge fund will be taxable to the tax-exempt entity as unrelated debt-financed income.⁷³

UBTI does not, however, pass through corporations.⁷⁴ In order to accommodate tax-exempt investors, hedge funds will often create a parallel

⁶⁵ Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 324 (2007).

⁶⁶ See Samuel D. Brunson, *Taxing Investment Fund Managers Using a Simplified Mark-to-Market Approach*, 45 WAKE FOREST L. REV. 79, 84 (2010) (“Private investment funds are generally organized as limited partnerships.”).

⁶⁷ See I.R.C. § 701 (2006).

⁶⁸ See *id.* § 702(a).

⁶⁹ See, e.g., 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*, 61 TAX LAW. 807, 809 (2008) (“[Pass-through] structure prevents hedge fund income from being subject to two levels of tax, which would be the case if the funds were organized as United States corporations.”).

⁷⁰ Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 245 (2009).

⁷¹ Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172, 202.

⁷² § 512(c)(1).

⁷³ Treas. Reg. § 1.514(c)-1(a)(2) ex. 4 (as amended in 1980); see generally I.R.S. Tech. Adv. Mem. 96-51-001 (June 27, 1996) (explaining that debt-financed taxable income passes through partnerships).

⁷⁴ See Philip S. Gross, *Tax Planning for Offshore Hedge Funds—the Potential Benefits of Investing in a PFIC*, 21 J. TAX’N INVESTMENTS 187, 188 (2004) (“[I]f a U.S. tax-exempt investor invests in an

fund in a tax haven jurisdiction that is treated as a corporation for U.S. tax purposes.⁷⁵ The offshore fund will not owe taxes in its country of incorporation,⁷⁶ and because it is a non-U.S. corporation, it will also not owe taxes in the United States.⁷⁷ Moreover, it blocks any UBTI (including unrelated debt-financed income) from passing through to the tax-exempt investors. Therefore, in order to avoid paying taxes on their passive income attributable to leveraged investment funds, tax-exempt entities frequently invest through the offshore hedge fund.

II. TAX HAVENS AND HEDGE FUNDS

A. Using Tax Havens to Evade Taxes

There are a number of ways taxpayers can use tax havens to reduce or eliminate their liability for taxes. Among other things, taxpayers can hide money in offshore accounts and they can use a foreign corporation to defer and reduce their taxes.⁷⁸ The abusive use of tax havens by U.S. taxpayers costs the government between \$40 billion and \$70 billion annually in lost tax revenue.⁷⁹ Tax-exempt entities, however, have no need to engage in any

offshore hedge fund (which is classified as a corporation for U.S. federal income tax purposes), none of the U.S. tax-exempt investor's income from the fund would be UBTI even if the fund uses leverage . . .").

⁷⁵ The parallel offshore fund "either 'feeds' the primary fund as a single investor or coinvests directly in the underlying portfolio companies with the primary fund." Andrew W. Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 1)*, 95 TAX NOTES 1215, 1218 (2002).

⁷⁶ See, e.g., Micah A. Levy, *Impact of the American Jobs Creation Act of 2004 on the Internal Revenue Code Section 956(c)(2)(A) Exception from U.S. Property for "Deposits with Persons Carrying on the Banking Business,"* 24 ANN. REV. BANKING & FIN. L. 295, 301 (2005) ("[C]ertain foreign corporations that resided in tax havens could retain and reinvest their annual income without being taxed at the entity level. Consequently, the value of an interest in such a foreign corporation was not diminished by an annual corporate tax." (footnote omitted)).

⁷⁷ See I.R.C. § 11(d) (2006) (narrowing the income of a foreign corporation that the United States may tax).

⁷⁸ Other ways taxpayers can take advantage of tax havens include income blending (which can increase a taxpayer's foreign tax credit), loss allocation, and transfer pricing. Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 960 n.112 (2010).

⁷⁹ See TREASURY, TAX GAP, *supra* note 7, at 4. In order to combat taxpayers hiding assets offshore, the government requires a U.S. taxpayer to disclose on her tax return any interest she earned during the course of the year in any financial account, including a bank account, in a foreign country. See INTERNAL REVENUE SERV., FORM 1040: U.S. INDIVIDUAL INCOME TAX RETURN SCHEDULE B (2011), available at <http://www.irs.gov/pub/irs-pdf/f1040sb.pdf>. In addition, she would be required to file a report with the Commissioner of Internal Revenue if she had an interest in a foreign financial institution worth more than \$10,000. See 31 C.F.R. § 1010.350 (2011). Failure to declare and pay taxes on income can subject a taxpayer to civil and criminal penalties, see, e.g., I.R.C. §§ 6651(a)(3) (civil penalties), 7201 (criminal penalties), as can failure to accurately file an FBAR. 31 U.S.C. §§ 5321 (civil penalties), 5322 (criminal penalties).

of these abusive behaviors. Because they do not pay taxes, they do not need to hide, defer, or reduce their income.

In many tax haven jurisdictions, the government and the banks offer little, if any, information to the U.S. government about the financial activities of U.S. taxpayers there.⁸⁰ As a result, some taxpayers hide assets in offshore bank accounts.⁸¹ While U.S. taxpayers can legally deposit money in offshore bank accounts, the law requires them to declare and pay taxes on their foreign deposits.⁸² Some banks located in tax havens have helped U.S. taxpayers open overseas bank accounts and structure those accounts in a way such that the taxpayers remain invisible to the U.S. government.⁸³ Some even provide financial services to those taxpayers in a manner that prevents the U.S. government from finding out about those bank accounts.⁸⁴

Although a taxpayer may prefer to pay no taxes at all, even deferring the payment of her taxes provides a significant economic benefit.⁸⁵ Absent any antiabuse provision or significant administrative costs, rational U.S. taxpayers would generally make their investments through corporations organized in tax haven jurisdictions. Because those corporations would be treated as foreign corporations for U.S. purposes, they would not be subject to U.S. tax on their worldwide income. Instead, they would be taxable on certain income derived from sources in the United States⁸⁶ and any income that was effectively connected with a U.S. trade or business.⁸⁷

Many types of investment income earned by a foreign corporation are either not treated as U.S.-source income or are exempted from U.S. taxation. For example, capital gains earned by a nonresident are treated as

⁸⁰ See, e.g., Sullivan, *supra* note 7, at 956 (“And equally important to U.S. investors, the Cayman Islands government and Cayman financial institutions provide only limited information to the U.S. government about activities of U.S. investors there.”).

⁸¹ See Lee A. Sheppard, *The IRS’s PFIC Amnesty*, 128 TAX NOTES 1097, 1097 (2010) (“Forget little old ladies with untouched inherited Swiss bank accounts. Many of the tax scofflaws who confessed their sins to the IRS during the recent voluntary disclosure initiative . . . were rich investors hiding behind anonymous foreign corporations.”).

⁸² *Id.*

⁸³ S. PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 3 (2008), available at http://hsgac.senate.gov/public/_files/071708PSIRReport.pdf.

⁸⁴ *Id.*

⁸⁵ See, e.g., Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313, 334 (2004) (“The possibility of deferring taxes on income earned abroad until repatriation confers a valuable benefit on U.S. multinationals operating in low-tax foreign jurisdictions.”).

⁸⁶ I.R.C. § 881(a) (2006).

⁸⁷ *Id.* § 882(a)(1). Under a safe harbor provision, though, trading in stocks and securities by a foreign corporation (or other foreign person) does not constitute a U.S. trade or business unless the foreign person has an office or fixed place of business in the United States. *Id.* § 864(b)(2).

foreign-source income even if the property sold was located in the U.S.,⁸⁸ and returns earned on certain financial instruments by a foreign corporation are also treated as foreign-source income.⁸⁹ In addition, foreign corporations are not taxable by the U.S. on portfolio interest or interest on bank deposits that they earn.⁹⁰ To the extent that the foreign corporation earns U.S.-source interest, dividends, or other investment income that is taxable by the United States, it is taxed on that income at a flat 30% rate.⁹¹

As a result, it would often be advantageous for a U.S. taxpayer with significant investment income to form a corporation in a tax haven jurisdiction that imposes no income tax.⁹² Whenever the investor wanted to make an investment, she would contribute money to the foreign corporation, which the foreign corporation would then invest. Because the tax haven jurisdiction does not impose a tax, the foreign corporation would not be subject to any foreign taxes on its income. Moreover, because the corporation would be a foreign corporation, it would not be subject to U.S. tax on its capital gains or a potentially significant portion of its interest income. Finally, since corporations are separate taxpayers from their shareholders, the U.S. investor would not be taxable on the foreign corporation's gains until she realized the gain, either by receiving a dividend or by selling her shares of the corporation.

Tax deferral is advantageous to taxpayers and harmful to the government. Under time-value-of-money principles, "[t]he right to \$1 today is more valuable than the right to \$1 one year from today, by the amount that could be earned by investing \$1 for one year."⁹³ Therefore, a taxpayer generally prefers to defer her payment of taxes while the government prefers to receive payment earlier. This not only lowers the government's revenue from the first investor, but it violates the basic principle of horizontal equity that similarly situated people should pay a similar amount of tax.⁹⁴

⁸⁸ See *id.* § 865(a)(2).

⁸⁹ Treas. Reg. § 1.863-7(b)(2) (1991) (stating that generally, income from notional principal contracts is sourced to the residence of the taxpayer).

⁹⁰ I.R.C. § 871(h)–(i).

⁹¹ *Id.* § 881(a).

⁹² For example, the Cayman Islands have no corporate income tax. ERNST & YOUNG, THE 2010 WORLDWIDE CORPORATE TAX GUIDE 162 (2010), available at http://www2.eycom.ch/publications/items/tax/2010_worldwide_corporate_tax_guide/2010_EY_worldwide_corporate_tax_guide.pdf.

⁹³ Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565, 565 (1983).

⁹⁴ Susan Pace Hamill, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, 54 ALA. L. REV. 1, 49 (2002) (“Horizontal equity dictates that similarly situated taxpayers should be treated similarly, meaning that taxpayers within the same ability to pay range should bear equivalent tax burdens.”). Congress has enacted a number of regimes in order to eliminate the advantages of investing through offshore corporations. Currently, the principal regimes are the subpart F rules and the PFIC rules. See *supra* note 8. The subpart F rules were enacted specifically to attack the problem of tax deferral and other “‘tax haven’ devices.” S. REP. NO. 87-1881, at 78–79 (1962). Under subpart F, certain

Table 1 illustrates the difference between the investment returns of two investors, each of whom initially invests \$100, and each of whom earns a 10% return on her investment. Investor *A* invests without any current tax (e.g., through a tax haven corporation). At the end of year five, she repatriates her earnings and pays tax at a rate of 35% on her gain. Investor *B* pays tax annually on her gains at a 35% rate and reinvests the after-tax amount. At the end of year five, Investor *A* has earned a total return of almost 40%, while Investor *B* has earned a total return of about 37%; by virtue of deferring her taxation until the end of the five-year period, Investor *A* has earned over 2.5 percentage points more, after taxes, on her investment.⁹⁵

TABLE 1

	Investor A	Investor B
Initial Investment	\$100.00	\$100.00
Year 1	\$110.00	\$106.50
Year 2	\$121.00	\$113.42
Year 3	\$133.10	\$120.79
Year 4	\$146.41	\$128.65
Year 5	\$161.05	\$137.01
Tax (at 35%)	\$21.37	\$0.00
Net Gain	\$39.68	\$37.01

It is important to note that the amount of tax savings that deferral provides varies with the length of the investment and the investor's return.⁹⁶ Compare Table 2, which demonstrates various after-tax returns enjoyed by Investor *A*, the deferring taxpayer, with Table 3, which demonstrates the lower after-tax returns available to Investor *B*, who pays taxes on her gain annually. As the expected return and the expected duration of the investment increase, the value of deferral increases significantly. If a taxpayer invests \$100 and earns a 5% return for twenty years, she will end

U.S. shareholders of controlled foreign corporations are required to include in their gross income their pro rata share of the corporation's subpart F income, whether or not such income is distributed to them. § 951(a)(1). In essence, the subpart F rules transform a foreign corporation into a pass-through entity with respect to certain types of income, eliminating the deferral that the corporate form would otherwise provide U.S. investors. The PFIC rules, on the other hand, subject shareholders of a PFIC to a punitive interest regime on unusually large distributions and on the sale of their shares. § 1291(a). By requiring shareholders to pay interest on their deferred income, the PFIC regime eliminates the economic advantages to the shareholders of deferring the payment of tax. *See supra* note 93 and accompanying text.

⁹⁵ Note that these numbers only apply if Investor *B* pays taxes out of her investment return. If she pays her taxes out of other income, her money will grow in the same way Investor *A*'s money grows. However, paying her taxes out of other income reduces that income which, in turn, reduces the amount of consumption she can enjoy.

⁹⁶ I am indebted to Professor Thomas Brennan at Northwestern University School of Law for highlighting this point.

up with \$17.88 more if she is able to defer her payment of taxes until the end. Similarly, if she invests the \$100 and can obtain a 25% return, after only five years she will have \$12.50 more if she can defer her taxes. Deferral has real value to investors so, to the extent they can, it makes economic sense for them to invest through tax havens.

TABLE 2: INVESTOR A

		Years			
		5	10	15	20
Returns	5%	\$117.96	\$140.88	\$170.13	\$207.46
	10%	\$139.68	\$203.59	\$306.52	\$472.29
	15%	\$165.74	\$297.96	\$563.91	\$1,098.82
	20%	\$196.74	\$437.46	\$1,036.46	\$2,526.94

TABLE 3: INVESTOR B

		Years			
		5	10	15	20
Returns	5%	\$117.34	\$137.69	\$161.57	\$189.58
	10%	\$137.01	\$187.71	\$257.18	\$352.36
	15%	\$159.23	\$253.54	\$403.71	\$642.82
	20%	\$184.24	\$339.46	\$625.43	\$1,152.31

B. Tax-Exempt Investments in Tax Haven Corporations Are Not Evasive

In some ways, a tax-exempt entity's ability to avoid taxes, including UBTI, by investing through an offshore blocker corporation looks indistinguishable from a U.S. taxpayer's abusive use of a tax haven corporation. Absent the offshore blocker corporation, the tax-exempt entity would presumably have invested in a leveraged hedge fund (that is, a hedge fund that had borrowed money), so some portion of its income would consist of unrelated debt-financed income, and it would owe taxes on that amount. On the other hand, if the tax-exempt entity had tried to block its unrelated debt-financed income by investing through a *domestic* corporation, the tax-exempt entity would not earn unrelated debt-financed income and would not owe taxes. The corporation, however, would pay taxes on its income at a 35% rate.⁹⁷ The corporation's taxes would indirectly reduce the tax-exempt entity's return.⁹⁸ By investing through a tax haven

⁹⁷ See § 11(b)(1)(D) (imposing a rate of 35% if the taxable income exceeds \$10 million).

⁹⁸ That is, if a tax-exempt entity owned 10% of the outstanding equity of a corporation and the corporation earned \$100, the tax-exempt entity's share would be \$10. However, if the corporation owed taxes at a 35% rate, the corporation would only have earned \$65 after taxes, and the tax-exempt entity's

corporation, though, the tax-exempt entity can almost entirely avoid directly or indirectly paying taxes.

Such reduction, however, does not rise to the level of inappropriate tax evasion by tax-exempt entities. Judge Learned Hand famously wrote that a taxpayer “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,” provided the transaction is “within an exception of the tax law.”⁹⁹ And, under current law, a tax-exempt entity’s use of a tax haven blocker corporation to avoid UBTI is clearly within an exception of the tax law. The subpart F and PFIC antiabuse provisions, enacted to prevent taxpayers from taking advantage of tax haven jurisdictions,¹⁰⁰ explicitly carve tax-exempt entities out of their scope.¹⁰¹

But tax-exempt entities’ ability to make investments that are effectively leveraged is not just a matter of a technical reading of the antiabuse provisions. There are situations in which the tax law expressly permits a tax-exempt entity to invest in an investment fund that borrows money. For example, tax-exempt entities can invest in mutual funds.¹⁰² Although not true pass-through entities for tax purposes, the tax treatment of mutual funds eliminates the second level of taxation and treats them as quasi-pass-through entities.¹⁰³ While the Investment Company Act of 1940

share would be reduced to \$6.50. Effectively, by investing in a taxable U.S. corporation, the tax-exempt entity has indirectly paid the tax it would have owed if it were not exempt.

⁹⁹ *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

¹⁰⁰ *See supra* note 8.

¹⁰¹ Although the Treasury Regulations do not say so explicitly, they imply that subpart F income earned by a tax-exempt entity is not treated as UBTI, and therefore, the tax-exempt entity is not taxable on its subpart F income. The PFIC regulations are more explicit: the PFIC rules only apply to tax-exempt entities if a dividend from the PFIC would be UBTI even absent the PFIC rules (e.g., if the tax-exempt entity borrowed money in order to purchase the PFIC shares). *Treas. Reg. § 1.1291-1(e)(1)* (as amended in 2004).

¹⁰² *See, e.g.,* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 198 (2007) (“In 2005, more than half of all mutual fund assets were held in tax-deferred accounts or tax-exempt funds, more than 60% of all fund shareholders invest through tax-deferred accounts, and nearly 60% view tax-deferred retirement plans as their primary source for purchasing funds.” (footnote omitted)).

¹⁰³ John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591, 595–96 (2009) (“[U]nlike most corporations, a mutual fund is taxed only on the amount of earnings it retains. To get this specialized ‘pass through’ tax treatment, a mutual fund must meet requirements . . . under Subchapter M of the Internal Revenue Code.”). Essentially, if a mutual fund qualifies as a regulated investment company under I.R.C. § 851, it can deduct from its taxable income the amount of dividends it paid to shareholders. *See* I.R.C. § 852(b)(2)(D) (2006). Shareholders, in turn, are not required to treat all of the mutual fund dividend as ordinary income; instead, the character of the income in the hands of the mutual fund passes through to the shareholders. *See, e.g.,* § 852(b)(3)(B).

limits the amount of leverage a mutual fund can employ,¹⁰⁴ mutual funds can borrow money.¹⁰⁵ Some mutual funds even act like hedge funds, trying to replicate hedge-fund strategies and returns and employing leverage to the extent the law permits.¹⁰⁶ Even to the extent that mutual funds act like leveraged hedge funds, though, UBTI does not pass through mutual funds to their tax-exempt investors.¹⁰⁷

In addition, tax-exempt entities can invest in certain financial instruments that effectively provide a leveraged return without requiring a tax-exempt entity to formally borrow money.¹⁰⁸ Such implicit leverage is not, however, treated as unrelated debt-financed income. An option, for example, allows an investor to pay a small upfront amount (an “option premium”) for the right to purchase or sell a security at a set date for a set price.¹⁰⁹ An option provides “an element of leveraged profit potential because the purchase price of the option is likely to be a fraction of the value of the underlying security.”¹¹⁰ However, UBTI does not include gains recognized by tax-exempt entities on options.¹¹¹

¹⁰⁴ See 15 U.S.C. § 80a-18(a)–(g) (2006) (prohibiting closed-end funds from issuing debt securities without sufficient asset coverage).

¹⁰⁵ See Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 28–29 (2006) (“Registered investment companies, mutual funds, on the other hand, may use leverage but they operate under direct limits.”).

¹⁰⁶ See Davidoff, *supra* note 71, at 235 (“These funds employ ‘hedge fund like’ trading strategies and employ leverage and hedging to the extent permitted under the Investment Company Act.”).

¹⁰⁷ See James R. Brown Jr., *Commodity-Linked Instruments and the Proper Scope of Mutual Fund Taxation*, 112 TAX NOTES 505, 513 (2006) (“[A] distribution from a [regulated investment company] is generally not UBTI . . . even if the distribution is attributable income that is UBTI . . .”).

¹⁰⁸ See generally LePree, *supra* note 69, at 834–39 (discussing short sales, options, futures contracts, and notional principal contracts). Leverage magnifies the volatility of an investment, essentially increasing an investor’s potential gain and potential loss. John Hughes, Jing Liu & Jun Liu, *On the Relation Between Expected Returns and Implied Cost of Capital*, 14 REV. ACCT. STUD. 246, 254 (2009). This magnification of the potential risk and reward inherent in leverage occurs because an investor is earning a return on more money than he personally has at risk. Assume that an investor has \$100 to invest. If he invests that \$100 in one share of stock and, by the end of the year, that stock appreciates to \$105, he has earned a 5% return on his investment. If, however, he still has \$100 to invest but in addition borrows \$100, he can buy two shares of stock. At the end of the year, his stock will be worth \$210. If he were to sell the stock, he could pay back the loan and still have \$110 (ignoring, for purposes of this example, any interest he had to pay)—a return of 10%! Although he still only had \$100 of his own money at risk, using leverage, he was able to double his return. It is important to note, however, that while leverage multiplies an investor’s gains if he has gains, it also multiplies his risks. An investor’s equity will be wiped out much more quickly if the investment goes wrong. See LePree, *supra* note 69, at 808–09.

¹⁰⁹ See, e.g., Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L.J. 1, 7 (2007).

¹¹⁰ Saul S. Cohen, *The Challenge of Derivatives*, 63 FORDHAM L. REV. 1993, 2002 (1995).

¹¹¹ I.R.C. § 512(b)(5)(B) (2006) (“There shall also be excluded [from UBTI] all gains or losses recognized, in connection with the organization’s investment activities, from the lapse or termination of options to buy or sell securities . . . or real property . . .”).

Likewise, short sales do not create unrelated debt-financed income unless the tax-exempt entity actually borrows money in order to consummate the sale.¹¹² In a short sale, the seller sells stock that she does not actually own, instead borrowing the stock to deliver it to the buyer.¹¹³ Short sales “allow an investor to increase both risk and reward by magnifying the gain or loss relative to the investor’s initial financial outlay” in the same way that a leveraged investment, taxable as unrelated debt-financed income, increases the risk and return of an investment.¹¹⁴

Tax-exempt entities can also enter into equity swaps—financial instruments in which two parties agree to make periodic payments to each other.¹¹⁵ The amount of the payments is based on an objective financial reference.¹¹⁶ Because swaps require no initial financial payment, they provide investors with an effectively leveraged return.¹¹⁷ In spite of their implicit leverage, though, swaps also do not produce UBTI.¹¹⁸

Blocker corporations can and do employ leverage in making their investments. Generally speaking, they borrow to the same extent as the onshore funds that pass unrelated debt-financed income through to tax-exempt entities.¹¹⁹ If the purpose of the unrelated debt-financed income rules were to prevent tax-exempt entities from employing leverage, blocker corporations should also trigger a tax-exempt investor’s recognition of UBTI. But the IRS has directly addressed the question of whether blocker corporations pass UBTI through to tax-exempt shareholders. In a number of rulings, the IRS has looked at a tax-exempt entity that formed and capitalized a foreign corporation, which in turn invested in a leveraged partnership and distributed its income from the partnership to the tax-exempt entity. After analyzing the transaction, the IRS ruled that the tax-

¹¹² Rev. Rul. 95-8, 1995-1 C.B. 108.

¹¹³ See, e.g., Ellen Taylor, *Teaching an Old Law New Tricks: Rethinking Section 16*, 39 ARIZ. L. REV. 1315, 1322 n.27 (1997).

¹¹⁴ LePree, *supra* note 69, at 835.

¹¹⁵ See, e.g., Don M. Chance, *Equity Swaps and Equity Investing*, 7 J. ALTERNATIVE INVESTMENTS 75, 75 (2004).

¹¹⁶ See, e.g., Brunson, *supra* note 109, at 8.

¹¹⁷ Chance, *supra* note 115, at 90 (“An equity swap is leveraged. There is no initial outlay By paying an interest rate, whether fixed or floating, an equity swap appears to be similar to a leveraged position in equity.”).

¹¹⁸ See, e.g., Treas. Reg. § 1.512(b)-1(a)(1) (as amended in 1992) (“[I]ncome from notional principal contracts [i.e., swaps] . . . shall be excluded in computing unrelated business taxable income.”).

¹¹⁹ Andrew W. Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 2)*, 95 TAX NOTES 1381, 1388 (2002) (“If a tax-exempt entity invests directly in a hedge fund, it may realize a portion of its gains as UBTI, assuming that the hedge fund borrows to fund investments. If the entity instead invests in the hedge fund through a Blocker, the Blocker will earn the leveraged returns.”).

exempt entity would not recognize any UBTI as a result of its indirect investment in the leveraged partnership.¹²⁰

The problem with tax-exempt entities' use of leverage, then, cannot be the leverage itself; tax-exempt entities earn tax-free returns on a wide range of investments in leveraged investment funds—as long as the fund is structured as a corporation rather than a partnership—and in financial instruments that provide a leveraged return. Instead, the purpose of the unrelated debt-financed income rules must be to prevent the abusive behaviors in which Congress believed tax-exempt entities were engaging.¹²¹

Likewise, the problem with tax-exempt entities investing in tax haven blocker corporations cannot be the tax-avoidance motive of the tax-exempt entities. Because tax-exempt entities are not generally subject to tax, they do not face the same incentives as taxable persons to evade taxes by hiding their assets or deferring their income in tax haven jurisdictions. Rather, their use of tax haven jurisdictions fits the technical contours of the tax law and is anticipated and condoned by the tax law and the IRS. Tax-exempt entities' use of tax haven jurisdictions is therefore not abusive. While Congress may have legitimate reasons for preventing U.S. persons from putting their money in tax haven companies, the fact that tax-exempt investors invest through tax havens is not one of them.¹²²

C. *Permitting Tax-Exempt Entities to Invest In Hedge Funds Does Not Harm Society*

Any discussion of the mechanics and taxation of tax-exempt entities' investment in hedge funds should address the normative question of whether tax-exempt entities should be permitted to invest in hedge funds in the first instance. Popular discourse is schizophrenic when it comes to hedge funds: they are alternatively lionized and vilified.¹²³ If we believe that tax-exempt entities should serve the public good, it makes sense to ensure that their permissible investments also contribute to the public welfare.

¹²⁰ See I.R.S. Priv. Ltr. Rul. 2002-51-016 (Sept. 23, 2002); I.R.S. Priv. Ltr. Rul. 2002-51-017 (Sept. 23, 2002); I.R.S. Priv. Ltr. Rul. 2002-51-018 (Sept. 23, 2002); I.R.S. Priv. Ltr. Rul. 1999-52-086 (Sept. 30, 1999).

¹²¹ See *supra* Part I.B.

¹²² For example, one commentator has argued that distributions by foreign corporations to tax-exempt entities should be included in UBTI. His argument, however, is not that tax-exempt entities are abusing the tax system by investing in offshore corporations. Instead, he asserts that “[i]f a tax-exempt U.S. investor invests in a foreign corporation that is exempt from U.S. corporate income tax, there may be a marginal investment incentive to invest uniquely American capital outside the United States.” Robert H. Dilworth, *Federal Income Tax Reform: International Recommendations*, 129 TAX NOTES 1113, 1121 (2010). Encouraging U.S. persons to keep their capital invested in the United States may be an appropriate Congressional purpose, but it is the design of the unrelated debt-financed income rules that, in the first instance, incentivizes tax-exempt entities to invest through tax haven corporations.

¹²³ See, e.g., Brunson, *supra* note 66, at 79.

And arguably, hedge funds provide value both to their investors and to society at large. Hedge funds provide tax-exempt entities with a way to diversify their portfolios while earning a larger return on their investment than they otherwise might be able to earn.¹²⁴ In addition, hedge funds provide liquidity to the public markets.¹²⁵ Liquidity is “a public good with positive externalities for all traders,”¹²⁶ and its provision should be encouraged. Moreover, tax-exempt entities themselves provide the markets with significant capital investment.¹²⁷ In 2006, tax-exempt entities’ investments were estimated to represent slightly more than one-third of all worldwide investments in hedge funds;¹²⁸ if those assets were pulled, hedge funds’ ability to provide liquidity would be significantly impaired.

Whether hedge funds provide positive externalities or not, however, the tax law should not casually change the rules underlying investment decisions of taxpayers. There is no explicit assertion, in either the legislative history of the unrelated debt-financed income rules or the current debates surrounding tax havens, that tax-exempt entities should not invest in hedge funds. In addition, there is nothing implicit in the unrelated debt-financed income rules or the current debates suggesting that tax-exempt entities should not invest in hedge funds.¹²⁹ Absent an indication that Congress intends to prevent tax-exempt entities from investing in hedge funds, then, the tax law should minimize the extent to which it prevents them from doing so.

D. Other Investors in Tax Haven Blockers

Although tax-exempt entities’ investments in offshore funds are not abusive, tax-exempt entities are not the only investors in offshore hedge funds. Some investors are non-U.S. persons who want to avoid subjecting

¹²⁴ Cauble, *supra* note 53, at 704–05 (“Tax-exempt entities invest in these funds in order to diversify their investment portfolios and earn high returns on their investment.”).

¹²⁵ See Carole Comerton-Forde et al., *Time Variation in Liquidity: The Role of Market-Maker Inventories and Revenues*, 65 J. FIN. 295, 325 (2010) (“Clearly, there are other competing liquidity suppliers, such as market makers on regional exchanges, proprietary trading desks at various Wall Street firms, and hedge funds following a market-making strategy.”).

¹²⁶ *Id.* at 326. It is necessary not to overstate the importance of liquidity. “[B]eyond a certain point, increased liquidity may have costs which exceed its benefits.” Lawrence H. Summers & Victoria P. Summers, *The Case for a Securities Transactions Excise Tax*, 48 TAX NOTES 879, 883 (1990). Still, until that point, liquidity is a valuable public good, and the existence of hedge funds that stand ready to buy and sell securities helps maintain liquid markets.

¹²⁷ Taylor, *supra* note 64, at 6 (“Tax-exempt organizations, and in particular section 401(a) trusts and section 401(k) plans, are an important source of capital market investments.”).

¹²⁸ Sullivan, *supra* note 10, at 258 (excluding funds of funds).

¹²⁹ See generally Cauble, *supra* note 53, at 720–22 (noting that the unrelated debt-financed income rules are typically justified as preventing oversubsidization of tax-exempt entities and preventing sale-leaseback transactions).

themselves to U.S. taxation.¹³⁰ Others, though, are U.S. taxpayers. In spite of the Code's antiabuse rules, an investment through an offshore fund may be advantageous in certain circumstances to some small portion of U.S. taxpayers,¹³¹ particularly where an investor anticipates an outsized return.¹³² But offshore hedge funds do not just facilitate better returns for honest investors: they also provide anonymity to investors, making it easier for U.S. taxpayers to evade taxes.¹³³

Hedge fund managers may also prefer to manage offshore hedge funds. While they can no longer defer their fee income for tax purposes,¹³⁴ being offshore nonetheless has significant advantages. Offshore hedge funds can avoid state partnership fees, minimize their tax shelter reporting requirements, and avoid state taxation.¹³⁵ Moreover, in order to avoid being governed by the Investment Company Act of 1940, a hedge fund organized in the United States must have fewer than 100 investors.¹³⁶ A hedge fund incorporated outside of the United States has no such limitation.¹³⁷

Attacking the viability of offshore corporations as investment vehicles would certainly hurt tax-exempt investors. Their returns would be reduced by the amount of taxes that the offshore fund would suddenly be required to pay. Even if the tax-exempt entity were to try to reduce its tax by shifting its investment to an onshore hedge fund, it would still have to pay some amount of tax and, in addition, would face the administrative burden of

¹³⁰ See, e.g., Adam H. Rosenzweig, *Not All Carried Interests Are Created Equal*, 29 Nw. J. INT'L L. & BUS. 713, 747 n.155 (2009). Foreign investors in U.S. private equity funds may want a blocker in order to avoid "potential U.S. tax liabilities and myriad U.S. tax filing requirements. With an investment in a single U.S. fund, a non-U.S. investor can find itself filing returns and paying tax not just to the IRS but also to dozens of states and even some cities." Neil Marcovitz & Christian M. McBurney, *Canadian Private Equity Fund Investors and Choice of Entity for a U.S. Blocker*, 113 J. TAX'N 214, 214 (2010). In the private equity context, however, blockers are generally domestic entities treated as corporations for tax purposes. *Id.* at 215. Because such blockers would be subject to taxes at ordinary corporate rates, it suggests that non-U.S. investors are more interested in avoiding U.S. tax filing requirements than in avoiding U.S. taxes altogether.

¹³¹ See Gross, *supra* note 74, at 191 ("While an investment in a PFIC . . . generally connotes bad things from a tax perspective, surprisingly, they actually can be *good* tax planning vehicles in certain circumstances.").

¹³² *Id.* at 194.

¹³³ See Lee A. Sheppard & Martin A. Sullivan, *Offshore Explorations: Caribbean Hedge Funds, Part I*, 118 TAX NOTES 95, 95 (2008). Anonymity facilitates tax evasion because "if income is not independently reported by the source, the likelihood of voluntary compliance declines precipitously." Sullivan, *supra* note 10, at 255. And offshore hedge funds do not report their shareholders' income to the IRS. Sheppard & Sullivan, *supra* at 95.

¹³⁴ See Rosenzweig, *supra* note 130, at 748.

¹³⁵ Gross, *supra* note 74, at 193-94.

¹³⁶ 15 U.S.C. § 80a-3(c)(1) (2006).

¹³⁷ See Timothy A. Canova, *Banking and Financial Reform at the Crossroads of the Neoliberal Contagion*, 14 AM. U. INT'L L. REV. 1571, 1605 n.135 (1999).

filing a return with the IRS.¹³⁸ Moreover, tax-exempt entities' need to avoid UBTI is used to legitimize the existence of offshore hedge funds.¹³⁹ Tax-exempt entities are generally viewed positively as providing public goods.¹⁴⁰ Without tax-exempt investors to protect, the *raison d'être* for offshore hedge funds becomes significantly less sympathetic, especially in light of the potential abuses they can foster.¹⁴¹

¹³⁸ See Treas. Reg. §§ 1.511-3(b) (1958), 1.6012-2(e) (as amended in 2007) (requiring tax-exempt entities to file a Form 990-T for any year in which they receive \$1000 or more of UBTI). The administrative burden of filing a Form 990-T may be substantial. The IRS estimates that the average time required to file a Form 990-T is about 142 hours, including the time necessary for recordkeeping, learning about the law or the form, preparing the form, and sending it to the IRS. INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 990-T 22 (2010), available at <http://www.irs.gov/pub/irs-pdf/i990t.pdf>.

¹³⁹ See, e.g., *Offshore Tax Issues: Reinsurance and Hedge Funds: Hearing Before the S. Comm. on Fin.*, 110th Cong. 10 (2007) (statement of Suzanne Ross McDowell, Partner, Steptoe & Johnson, LLP) (“At first blush, blocker entities look like a loophole that should be shut down. However, blocker entities are frequently used to avoid the application of the debt-financed income rules to legitimate, nonabusive transactions that were not the intended target of the rules.”); *id.* at 13 (statement of Daniel S. Shapiro, Partner, Shulte, Roth, & Zabel) (“From a tax policy standpoint, there appears to be little basis for imposing UBIT on passive investment income received by tax-exempt organizations where it has no liability for the leverage, has no control over the investments, or the extent of the use of leverage.”); *id.* at 14 (statement of Dr. Jane G. Gravelle, Senior Specialist in Economic Policy, Government and Finance Division, Congressional Research Service) (“Indeed, when questioned by a reporter about the use of offshore entities, a spokesman for Duke University stressed the use of endowments for financial aid and research.”).

¹⁴⁰ See, e.g., Daniel Shaviro, *Assessing the “Contract Failure” Explanation for Nonprofit Organizations and Their Tax-Exempt Status*, 41 N.Y.L. SCH. L. REV. 1001, 1007 (1997) (“I believe that fundamentally the case for tax exemption, as well as other special tax and non-tax benefits for nonprofit organizations, must rest squarely, and more or less exclusively, on the view that the activities these organizations engage in merit public support. . . . [T]he organizations are providing public goods or engaging in activities that have positive externalities.”).

¹⁴¹ Clearly, U.S. tax-exempt entities are among the most important and the most sympathetic investors in offshore hedge funds. See Sullivan, *supra* note 10, at 258. But non-U.S. investors should be similarly sympathetic—like U.S. tax-exempts, they are not taxable in the U.S., except on income effectively connected with a U.S. business and on certain of their U.S.-source income. See I.R.C. §§ 871, 881–82 (2006). Of course, a foreign investor does not eliminate the taxation of its U.S.-source income by investing through a blocker corporation; instead, the blocker corporation faces taxation, and the foreign investor's return is reduced by the same amount as if the foreign investor had invested directly. Still, foreign investors generally prefer to invest in the U.S. through a foreign corporation because that allows the foreign investors to remain anonymous to the IRS and because it allows them to avoid any duty to file a U.S. return. Sheppard & Sullivan, *supra* note 133, at 98 (“Foreign investors prefer to invest in the United States through corporations because their anonymity is preserved and because they are not required to file a U.S. tax return unless they have something else going on.”). But the Stop Tax Haven Abuse Act would not necessarily hurt U.S. investment by non-U.S. persons. Instead, foreign investors could set up their own blocker corporations in tax haven countries. Because a foreign investor's blocker would presumably be managed in the foreign investor's home jurisdiction, it would continue to provide the anonymity that foreign investors desire.

III. THE DEBATE OVER THE UNRELATED DEBT-FINANCED INCOME RULES

Commentators generally dislike the application of the unrelated debt-financed income rules to tax-exempt entities' hedge fund investments.¹⁴² They point out that the UBTI and unrelated debt-financed income provisions of the Code were enacted before tax-exempt entities earned substantial income from investment partnerships.¹⁴³ As a result of these rules, tax-exempt entities' investment decisions, especially decisions regarding investment in hedge funds, private equity funds, and real estate investment partnerships, face significant distortions.¹⁴⁴ The unrelated debt-financed rules were not intended to prevent tax-exempt entities from investing, and hedge fund investments do not present the problems that the rules intended to solve.¹⁴⁵ Moreover, the congressional proposal to treat foreign corporations that are managed domestically as domestic corporations will further introduce distortions into tax-exempt entities' investment decisions without providing a material corresponding increase in federal revenue.¹⁴⁶

In reaction to these problems, commentators have proposed two modifications of the tax law that would eliminate the distortions in investment decisions faced by tax-exempt entities. The first proposal would entirely repeal the unrelated debt-financed income rules.¹⁴⁷ Without the unrelated debt-financed income rules, tax-exempt entities could invest in onshore hedge funds irrespective of the funds' borrowings. The second would keep the unrelated debt-financed income rules but amend the tax law so that unrelated debt-financed income does not pass through investment partnerships to a passive tax-exempt partner.¹⁴⁸ Repealing the pass-through of unrelated debt-financed income would "mitigat[e] distortions that

¹⁴² See, e.g., Taylor, *supra* note 64, at 16 ("Certainly the use of blockers to avoid debt-financed income points up the need to consider revisiting the debt-financed acquisition rules that . . . by general consensus, are both overbroad and too narrow." (footnote omitted)).

¹⁴³ See Cauble, *supra* note 53, at 700.

¹⁴⁴ See, e.g., *id.* at 700, 723.

¹⁴⁵ LePree, *supra* note 69, at 846 ("What [the unrelated debt-financed income rules] were not designed to do is to protect the charities themselves, which were not seen as being threatened in any way.").

¹⁴⁶ Cauble, *supra* note 53, at 723. The proposal is unlikely to raise significant revenue because tax-exempt entities can avoid taxation by shifting their investments out of hedge funds and into unleveraged investment vehicles. *Id.* This distortion could result in an inefficient allocation of capital, however, if, but for the tax law, the tax-exempt entity would have invested in the hedge funds. *Id.*

¹⁴⁷ LePree, *supra* note 69, at 848.

¹⁴⁸ Cauble, *supra* note 53, at 723–24; LePree, *supra* note 69, at 851. It is worth noting that, of the two solutions, repealing the unrelated debt-financed income rule is both the cleanest and the easiest. Just repealing the unrelated debt-financed income rule would not, however, address the distortions that arise because active business UBTI passes through investment partnerships, while preventing all UBTI from passing through qualifying investments partnerships would address both issues. This Article is solely concerned with leveraged passive investments by tax-exempt entities, however, and whether active business income should pass through investment partnerships to tax-exempt entities is beyond its scope.

influence investment decisions made by tax-exempt entities” while modernizing the tax law to reflect the economic realities of tax-exempt entities in the modern economy.¹⁴⁹

Although either solution would eliminate the distortions that the unrelated debt-financed income rules cause, the goal of preventing distortions does not seem to motivate congressional critics of tax havens. In fact, the goal of eliminating distortions relating to tax-exempt entities may not be compelling to Congress. Instead, Congress wants to discourage the use of tax haven jurisdictions. While ending the pass-through of unrelated debt-financed income earned by passive partners would eliminate tax-exempt entities’ need to invest through blocker corporations organized in tax haven jurisdictions, it would do nothing to discourage them from doing so.

A. The Unrelated Debt-Financed Income Rules Distort Tax-Exempt Entities’ Legitimate Investment Decisions

A good tax system interferes minimally with taxpayers’ economic decisionmaking. An ideal tax system would raise revenue without distorting taxpayers’ actions in comparison with how the taxpayers would have acted in a world without taxes.¹⁵⁰ Distortions are bad because they change what an actor would do in a tax-free world; in the interest of efficiency, the tax law tries to minimize the effect that taxes have on taxpayers’ decisions.¹⁵¹

But tax-exempt entities are, by their very nature, subject to significant distortions of their behavior. In order to qualify for an exemption, for example, tax-exempt entities cannot be organized in order to earn a profit, and net earnings cannot inure to the benefit of shareholders.¹⁵² In addition,

¹⁴⁹ Cauble, *supra* note 53, at 724.

¹⁵⁰ See Yoram Margalioth, Note, *The Case for Tax Indexation of Debt*, 15 AM. J. TAX POL’Y 205, 254 (1998) (“The standards for a good tax system are its efficiency and its fairness. By the term efficiency we generally mean minimal interference with economic behavior to allow the allocation of economic resources to their most productive uses.” (footnotes omitted)).

¹⁵¹ Samuel D. Brunson, *Grown-Up Income Shifting: Yesterday’s Kiddie Tax Is Not Enough*, 59 KAN. L. REV. 457, 460 (2011).

¹⁵² See, e.g., I.R.C. § 501(c)(7) (2006) (exempting from tax “[c]lubs organized for pleasure, recreation, and other nonprofitable purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder.”). Notwithstanding the general rule that an organization must forgo profits in order to be exempt from tax, there is nothing inherent about tax-exempt entities that demands they not be profit-oriented. Anup Malani and Eric A. Posner argue that not only do for-profit charities (such as Google.org) exist, but that they should get some of the tax benefits currently enjoyed only by non-profit charities. Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2020 (2007). With or without the tax benefits, though, it is becoming easier and easier to organize a for-profit charity. Several states permit a limited liability company “to become a low-profit limited liability company . . . when organized for a business purpose and operated to significantly further charitable purposes but without a significant purpose to produce income or asset appreciation.” Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 243 (2010).

tax-exempt entities often face significant limitations on how they can act. All but an insubstantial part of a public charity's actions, for example, must further its charitable purpose,¹⁵³ and the law severely curtails public charities' rights to engage in political speech.¹⁵⁴

In a world without the income tax, certain charitable entities might choose to distribute profits to their shareholders, to split their actions between charitable and noncharitable, or to fully exercise their right to political speech. Perhaps there is something inherent to tax-exempt entities that, even absent tax considerations, suggests that the types of entities that qualify for exemption from the federal income tax should not be able to do these things. It is far from clear, however, that these restrictions naturally adhere to tax-exempt entities.¹⁵⁵ Whether or not such activities are appropriate for tax-exempt entities, forgoing them is arguably the cost of being removed from the tax rolls.¹⁵⁶

If the rules regarding profits and net earnings, permissible actions, and political participation of tax-exempt entities are conceptualized as the cost of being tax-exempt, it may be that the UBTI and unrelated debt-financed income rules can also be considered costs of an entity's tax exemption. There is, admittedly, a much more tenuous link between problems with debt-financing and the nature of a tax-exempt entity than there is between an entity's use of its resources and its nature, but it is still plausible to argue that avoiding UBTI is a cost of the tax exemption. If that is true, the fact that some piece of anti-tax-haven legislation will distort the behavior of tax-exempt entities is not a compelling argument against that legislation. Instead, it just increases the cost to tax-exempt entities of their exemption.

B. Congress Did Not Intend to Tax Tax-Exempt Entities on Their Investment Income

The argument for changing the tax treatment of tax-exempt entities' investment income, then, must supplement the distortions argument. Tax-exempt entities have been removed from the familiar world of economic decisionmaking by deliberately circumscribing the decisions they are permitted to make. Because of this, any argument in favor of preserving tax-exempt entities' ability to invest through investment funds organized as

¹⁵³ Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 2008).

¹⁵⁴ I.R.C. § 501(c)(3).

¹⁵⁵ See, e.g., Samuel D. Brunson, *Reigning in Charities: Using an Intermediate Penalty to Enforce the Campaigning Prohibition*, 8 PITT. TAX REV. 125, 141–42 (2011) (“Just because a public charity engages in certain activities that are not themselves charitable in nature, it does not mean that those activities should cause the public charity to cease being considered a charitable entity. This is particularly true when . . . the activity that is not inherently charitable is closely connected to, and in furtherance of, the public charity's core charitable purpose.” (footnote omitted)).

¹⁵⁶ See *id.* at 130 (“The beneficial tax treatment available to public charities is not costless to the charities, however. The tax law imposes certain restrictions on the way a qualifying public charity can act.”).

partnerships should, instead of (or in addition to) focusing on distortions, focus on accomplishing the purposes underlying the exemption from tax of tax-exempt entities' passive income.

When Congress first enacted the unrelated business income tax, it deliberately removed passive income from the scope of the tax. As discussed above, Congress enacted the unrelated business income tax in order to "correct certain problems which have arisen in connection with tax-exempt organizations."¹⁵⁷ However, Congress believed that tax-exempt entities' passive income should not be subject to tax as UBTI "where [the passive income] is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations."¹⁵⁸ Moreover, unlike the active conduct of a business, Congress believed that tax-exempt entities' passive investments "are not likely to result in serious competition for taxable businesses having similar income."¹⁵⁹

But although Congress recognized that it was generally appropriate for tax-exempt entities to invest passively and that such investment did not harm taxable businesses, it proved itself willing to subject tax-exempt entities' passive income to taxation where it determined that such passive income was somehow abusive or anticompetitive. At the same time Congress generally affirmed that passive income was not subject to the unrelated business income tax, it carved out income earned as rent from certain sale-leaseback arrangements.¹⁶⁰

Congress had three objections to tax-exempt entities' participation in sale-leaseback transactions. First, Congress did not believe that sale-leaseback transactions constituted ordinary passive income. Instead, the tax-exempt entity was "trading on its exemption, since the only contribution it makes to the sale and lease is its tax exemption."¹⁶¹ Second, Congress was concerned that if sale-leasebacks went unchecked, eventually tax-exempt entities would "own the great bulk of the commercial and industrial real estate in the country."¹⁶² Third, Congress believed that tax-exempt entities' profits on the sale-leaseback transactions came because they were selling part of their exemptions.¹⁶³ Congress did not believe, however, that these problems attached to ordinary passive investments by tax-exempt entities;

¹⁵⁷ H.R. REP. NO. 81-2319, at 36 (1950); *see supra* Part II.B.

¹⁵⁸ H.R. REP. NO. 81-2319, at 38.

¹⁵⁹ S. REP. NO. 81-2375, at 30-31 (1950).

¹⁶⁰ McDowell, *supra* note 45, at 709.

¹⁶¹ S. REP. NO. 81-2375, at 31.

¹⁶² *Id.*

¹⁶³ *Id.* at 31-32 ("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.").

they solely tainted passive rents earned as a result of sale–leaseback transactions.¹⁶⁴

The Treasury Department highlighted two main problems with permitting tax-exempt entities to participate in the modified sale–leaseback transactions. First, because the acquisition indebtedness would be repaid from property’s future earnings and because the tax-exempt owner would not be taxable on those future earnings, tax-exempt entities would be able to pay “a considerably higher price than other purchasers can afford.”¹⁶⁵ This concern corresponds roughly to Congress’s concern in 1950 that, if unchecked, sale–leaseback transactions would lead to tax-exempt entities owning substantially all of the commercial and industrial real property in the United States.¹⁶⁶ The Treasury Department’s second concern was unrelated to the earlier Congress’s motivations for including income from supplement U leases¹⁶⁷ in UBTI. Instead, the Treasury Department worried that the income from sale–leaseback transactions would allow tax-exempt entities to grow “independent of the amount of contributions . . . which they receive from the public.”¹⁶⁸ Rather than focusing on the sale or trading of their exemptions, the Treasury Department wanted to ensure that tax-exempt entities had to rely on public support rather than becoming self-reliant as a result of their leveraged investments.

The history of the unrelated debt-financed income rules clearly demonstrates that Congress did not enact them in order to cause tax-exempt entities to be taxable on their passive income. Rather, it enacted the rules to prevent tax-exempt entities from facilitating other taxpayers’ abusive tax-reduction strategies.¹⁶⁹ Although the unrelated debt-financed income rules do transform some passive income earned by tax-exempt entities into taxable income, their aim was not to change the default rule that passive income is exempt from tax. Moreover, the debt-financed income rules were not, by their terms, limited to passive income earned by tax-exempt entities.¹⁷⁰

Still, some current members of Congress are wary of the use of tax haven jurisdictions by U.S. persons, whether the U.S. persons are taxable or

¹⁶⁴ See *id.* at 32.

¹⁶⁵ TAX REFORM STUDIES, *supra* note 62.

¹⁶⁶ See H.R. REP. NO. 81-2319, at 39 (1950).

¹⁶⁷ See *supra* notes 55–56.

¹⁶⁸ TAX REFORM STUDIES, *supra* note 62.

¹⁶⁹ *Id.* at 42 (stating that unrelated debt-financed income rules would “not have any immediate significant overall revenue effect” but instead would “prevent substantial future revenue losses.”).

¹⁷⁰ In their actual application, however, the unrelated debt-financed income rules principally would have caused a portion of passive income to become taxable; tax-exempt entities that were operating active businesses were subject to the unrelated business income tax whether or not they borrowed money.

tax-exempt.¹⁷¹ Any solution to the use of tax havens can have an effect on tax-exempt entities' passive income; although the tax exemption for passive income has a long history, the enactment of the unrelated debt-financed income rules (and, for that matter, the enactment of the unrelated business income tax in the first place) demonstrate that, if Congress believes that tax-exempt entities are behaving badly, it is willing to curtail the amount and type of income a tax-exempt entity can earn without paying taxes.

Although Congress did not originally intend for the unrelated debt-financed income rules to be anything but an antiabuse provision, one could argue that over the years their meaning has shifted. Members of Congress have recently expressed displeasure with the size of some tax-exempts, especially university endowments.¹⁷² However, congressional displeasure appears to focus on universities hoarding, instead of spending, their endowments rather than on the size of the endowments.¹⁷³

Moreover, if Congress is concerned with tax-exempt entities growing too large as a result of investing with borrowed money, the unrelated debt-financed income rules as currently written are a poor method of preventing such growth. As discussed above, they only prevent tax-exempt entities from incurring debt. The unrelated debt-financed rules do not set a limit on how large a tax-exempt entity can grow. They do not limit the return a tax-exempt entity can receive, as long as that return is not the result of borrowed money. And tax-exempt entities can still increase their risk and return through the use of various effectively leveraged financial instruments and investments in mutual funds and offshore hedge funds.¹⁷⁴ If Congress cares about the size of tax-exempt entities, it should address the problem directly rather than relying on provisions of the tax law that were never intended to do that work.

C. Fixing the Unrelated Debt-Financed Income Rules Would Not Eliminate the Abusive Use of Tax Havens

Even if a tax-exempt entity were not subject to the unrelated debt-financed income rules, a risk-averse tax-exempt entity may still prefer to make its hedge fund investments through an offshore blocker corporation. Professor Emily Cauble has proposed that tax-exempt entities should generally be permitted to make passive investments in leveraged

¹⁷¹ For example, Senators Carl Levin and Kent Conrad have introduced legislation that would "tighten rules that allow hedge funds and corporations in the United States to skirt federal taxes by opening shell companies overseas." David Kocieniewski, *Senate Bill Seeks to Raise Revenue by Closing Tax Havens*, N.Y. TIMES, Jul. 13, 2011, at B5.

¹⁷² See, e.g., Fred Stokeld, *Exempt Organizations Faced Challenges, Opportunities in 2008*, 122 TAX NOTES 50, 53 (2009) ("Grassley hammered schools with large endowments for not using more of their funds on tuition assistance.").

¹⁷³ See *id.*

¹⁷⁴ See *supra* notes 102–18 and accompanying text.

partnerships without facing UBTI liability.¹⁷⁵ She argues that this would eliminate distortions that tax-exempt entities face without undermining the goals that led to the enactment of the UBTI rules.¹⁷⁶ Professor Cauble's proposal necessarily includes a control test; under her proposal, an investment fund would only pass UBTI through to a tax-exempt investor if that investor owned 50% or more of the fund.¹⁷⁷ A tax-exempt entity investing passively may be concerned, however, that other partners could redeem their interests, and that the tax-exempt partner would become a majority interest holder, albeit unintentionally.

Moreover, the reason to premise the exemption from UBTI on limiting a tax-exempt entity's control of the partnership is to make sure that the tax-exempt entity does not cause the investment partnership to facilitate abusive transactions. Because the interests of taxable investors run contrary to the interests of tax-exempt entities with respect to abusive tax-motivated transactions, ensuring that the tax-exempt entity does not control the investment partnership discourages investment funds from participating in abusive transactions.¹⁷⁸ To the extent that Congress is serious about using the UBTI and unrelated debt-financed income rules to prevent abusive behavior by tax-exempt entities, it would be in Congress's interest not to adopt Professor Cauble's proposal wholesale but instead to limit the exception from the UBTI rules to a partnership where the sum of the interests of all tax-exempt entities together is less than 50% of the outstanding partnership interests. However, a group of tax-exempt partners would have parallel incentives; even if no single tax-exempt partner had owned more than 50% of the interests in the partnership, the results would be similar if two or more controlled more than 50% of the partnership. If Congress were instead to adopt a rule limiting the exception to UBTI to partnership where less than 50% of the interests were held by any tax-exempt investor, individual tax-exempt entities would have even less ability to ensure that the limit was not exceeded.

Moreover, tax-exempt entities may have non-tax reasons for investing in an offshore fund. Admittedly, a tax-exempt entity's return on its

¹⁷⁵ Cauble, *supra* note 53, at 723–24.

¹⁷⁶ *Id.* at 724.

¹⁷⁷ *Id.* at 725.

¹⁷⁸ If a tax-exempt entity controlled the investment partnership, it could enter into a sale–leaseback with a taxable person. For example, the taxable person might sell a manufacturing plant to the partnership for \$100,000, which the partnership would borrow from a bank. The partnership would pay annual interest of 5% to the bank. The partnership would then lease the building back to the taxable person for \$7000 a year. The partnership would pay \$5000 to the bank, but would receive \$7000 in rent, for a net gain of \$2000. Meanwhile, the taxable person would get deductions worth \$7000 a year. The tax-exempt entity would be willing to facilitate this transaction, because it would not pay any taxes on its gains. Taxable investors, on the other hand, may not want the additional taxable income, and could balk at the transaction. By ensuring that tax-exempt entities do not control the partnership, Congress would prevent the tax-exempt entity from forcing taxable partners to accept additional taxable income.

investment through an offshore corporation may be reduced by taxes. Even though an offshore hedge fund is generally organized in a tax haven country that does not impose taxes on the hedge fund, a portion of its U.S.-source income may be taxable, and U.S. payers may be required to withhold that tax upon payment.¹⁷⁹ A partnership, on the other hand, does not itself pay taxes and, to the extent that the tax law was changed to exempt from UBTI income earned through a passive investment in a partnership, the tax-exempt investor would also not pay taxes. In practice, however, hedge funds can significantly limit the amount of U.S.-source income they earn that is subject to withholding. There is no withholding imposed on a foreign corporation's capital gains,¹⁸⁰ for example, or on portfolio interest earned by a foreign corporation.¹⁸¹ And where income that could be earned by foreign hedge funds could have been subject to withholding, the foreign hedge funds often try to structure their investment in such a way as to fall outside the scope of the withholding rules.¹⁸² In practice, then, taxes are unlikely to materially diminish a tax-exempt entity's return earned through a foreign hedge fund as compared with the return earned through a domestic hedge fund.

Ultimately, although the proposals discussed above¹⁸³ provide a sensible treatment of tax-exempt entities' investments in investment funds, they do not address Congress's concern about taxpayers' use of tax havens to avoid paying taxes. Certainly, tax-exempt entities' investments in offshore hedge funds do not implicate the abuses that Congress would like to eliminate, but nothing about *allowing* tax-exempt entities to invest in leveraged partnerships without facing taxes would *require* them to shift their investments from offshore to onshore investment funds. Moreover, even if no tax-exempt entity could own more than 50% of a partnership, if tax-exempt entities collectively held most or all of the interests in an investment partnership, that partnership could again engage in abusive transactions that the unrelated debt-financed income rules were intended to prevent.

¹⁷⁹ I.R.C. §§ 881(a), 1441(a) (2006).

¹⁸⁰ Gains on the sale of property by a nonresident of the United States are treated as foreign-source income. *Id.* § 865(a)(2). As such, they are not subject to withholding. *See id.* § 1441(a) (requiring withholding on payments of U.S.-source income to nonresident alien individuals).

¹⁸¹ *Id.* § 871(h)(1).

¹⁸² Prior to 2010, for example, "many foreign-based hedge funds avoided withholding taxes on dividends by instead holding total return equity swaps on the equity of U.S. corporations." Reuven S. Avi-Yonah, *The Redemption Puzzle*, 128 TAX NOTES 853, 854 (2010). In 2010, Congress enacted I.R.C. § 871(m), which treats certain "dividend equivalent payments" as if they were dividends from sources within the United States. Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 541(a), 124 Stat. 71, 115 (2010) (to be codified at I.R.C. § 871(m)).

¹⁸³ *See supra* notes 147-49.

IV. REPLACING THE UNRELATED DEBT-FINANCED INCOME RULES WITH THE REPORTABLE TRANSACTION REGIME

Congress has a pressing interest in shutting down abusive behavior by U.S. taxpayers taking advantage of the low taxes and the general secrecy of tax havens. However, if it enacts antiabuse legislation without taking into account tax-exempt entities' legitimate use of tax haven blocker corporations, the legislation will detrimentally affect tax-exempt entities.¹⁸⁴ As such, should Congress circumscribe the ability of U.S. persons to use tax haven corporations, it should also provide an alternative route for tax-exempt entities to invest in hedge funds. Because the unrelated debt-financed income rules significantly distort the investment decisions of tax-exempt entities without providing any significant societal benefit, they should be repealed. At the same time, in order to prevent some taxpayers from taking advantage of tax-exempt entities' tax exemptions in order to evade taxes, the Treasury Department should expand the definition of "reportable transactions" to include such abusive behaviors.

A. Repeal the Unrelated Debt-Financed Income Rules

The simplest way to allow tax-exempt entities to continue to invest in hedge funds would be to repeal the unrelated debt-financed income rules. Their repeal alone would not necessarily cause tax-exempt entities to move their investments from tax haven hedge funds to onshore hedge funds, but Congress may enact anti-tax-haven legislation—such as the Stop Tax Havens Abuse Act (which would treat offshore hedge funds that are controlled in the United States as domestic corporations)—that would cause tax-exempt entities to take their investments out of offshore blocker corporations.¹⁸⁵

Repealing the unrelated debt-financed income rules, in conjunction with or separate from closing tax haven loopholes, could, however, create other tax problems. The impetus for the unrelated debt-financed income rules was to prevent tax-exempt entities from facilitating tax-evasive

¹⁸⁴ See Cauble, *supra* note 53, at 699 (“[T]he enactment of currently proposed legislation regarding the use of ‘blocker corporations’ could exacerbate this capital allocation problem, at least in the hedge fund context.” (footnote omitted)).

¹⁸⁵ If an offshore corporation that was controlled in the United States was treated as a domestic corporation for tax purposes, the offshore corporation would owe U.S. taxes, notwithstanding its being incorporated in a tax haven. Corporations pay taxes at a top marginal rate of 35%, with no lower rate imposed on capital gains or other types of income. I.R.C. § 11 (2006). Although tax-exempt entities would still pay no taxes when they received distributions from the offshore hedge fund by virtue of their exemption, any distribution would be 35% less than the amount of money initially earned by the hedge fund. An onshore hedge fund, in contrast, is generally organized as a partnership and would not pay entity-level taxes. Moreover, absent some type of UBTI, the tax-exempt entity will not pay taxes when the partnership earns the money or when it distributes the money. Therefore, if taxes were imposed on offshore hedge funds, tax-exempt (and, for that matter, taxable) investors should generally migrate to onshore hedge funds.

behavior by U.S. taxpayers, and specifically to end sale–leaseback transactions.¹⁸⁶ As we have seen, when Congress first tried to stop sale–leaseback transactions, taxpayers tweaked the form of the sale–leaseback in order to reduce their taxes.¹⁸⁷ And even after the unrelated debt-financed income rules were passed, taxpayers restructured their sale–leaseback transactions to continue using tax-exempt entities’ exemptions to reduce the taxes they paid.¹⁸⁸

Why have the unrelated debt-financed income rules been unable to prevent these transactions? In part, because the rules only focus on penalizing the tax-exempt entity for facilitating tax avoidance.¹⁸⁹ While the taxable party to the transaction compensates the tax-exempt entity for facilitating tax avoidance, the taxable party enjoys the real benefit; for purposes of the taxpayer, tax-indifferent parties are roughly fungible.¹⁹⁰ Taxable persons, who enjoy real financial benefit from lowering their tax bills, will continue to have an incentive to use tax-exempt and tax-indifferent entities to reduce their tax bills as long as they have no risk of being penalized as a result. And tax-exempt entities have very little incentive to avoid facilitating transactions that do not create UBTI even if the taxable counterparty uses their exemptions.¹⁹¹

¹⁸⁶ See *supra* Part III.B.

¹⁸⁷ See *supra* notes 55–61 and accompanying text.

¹⁸⁸ Stone, *supra* note 40, at 1521. Initially, taxpayers found non-exempt counterparties who were tax-indifferent (because, for example, they had a loss that they would be unable to fully use) to whom they could sell property and then lease it back. As the Treasury and Congress worked to shut down these sale–leaseback transactions through what would become the passive activity loss rules, taxpayers reversed the sale–leaseback transactions so that tax-exempt entities would lease their assets to the taxable person, who would then lease the property back to the tax-exempt seller but keep the accelerated depreciation. *Id.* at 1522. When Congress responded, the parties tweaked the transaction again so that the tax-exempt entity (or, increasingly, the municipality) would *sell* assets to the taxable person, who would lease them back, keeping only the depreciation deductions. *Id.* at 1522.

¹⁸⁹ See *id.* at 1523 (“Nonetheless, in formulating a legislative response, neither the Treasury nor Congress ever considered any approach that would tax the person trying to avoid tax. Instead, they reflexively focused on eliminating charities’ special ability and incentive to facilitate the avoidance.”).

¹⁹⁰ They are not, of course, completely interchangeable solely as a result of being exempt from tax. A taxable person would have to take into account different counterparty risk with respect to each tax-exempt entity. Counterparty risk is the risk that one party to a transaction may not be paid because the other party becomes insolvent, declares bankruptcy, or becomes otherwise unable or unwilling to pay amounts it owes. See, e.g., Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT’L L. 581, 608 n.105 (2010). But one tax-exempt entity’s exemption functions the same as the next entity’s.

¹⁹¹ A tax-exempt entity that facilitated shady tax transactions could potentially suffer reputational damage among donors and the public at large, but even if this were the case, the risk of reputational damage does not appear to have prevented tax-exempt entities from acting as facilitation parties to questionable transactions.

*B. Meeting the Goals of the Unrelated Debt-Financed Income Rules
Through Other Means*

The five concerns laid out by Congress and the Treasury Department that eventually led to the enactment of the unrelated debt-financed income rules can be divided into two categories: (1) concerns about unfair business practices and (2) concerns about tax avoidance. The ensuing years have demonstrated that the unfair-business-practice concerns have not materialized, which allows any new rule to focus instead on preventing tax avoidance.

1. Unfair Business Practices.—Congress and the Treasury Department worried that if tax-exempt entities could engage in sale–leaseback and other leveraged transactions, they would ultimately own a significant portion of real estate, would be willing and able to pay a higher price for investments than taxable persons, and would be able to fund themselves through their investments rather than relying on outside contributions.¹⁹² Ultimately, these concerns have proven to be unfounded.

In certain instances, tax-exempt entities are still able to purchase real property with borrowed money. In 1980, Congress permitted certain tax-exempt entities, primarily pension funds, to borrow money to purchase real property.¹⁹³ Among other things, proponents of allowing pension funds to make leveraged investments in real property argued that because of inflation, the government needed to facilitate pension funds' investment in real property.¹⁹⁴ Although the Treasury Department argued that debt financing was conventional in, but not essential to, real estate investment, it did not ultimately oppose the change.¹⁹⁵ As a result, since 1980, pension funds have been able to make leveraged investments in real property without being taxed on income from the leveraged property.

In spite of their ability to use borrowed money to purchase real property, pension funds remained underinvested in the real property sector. Various studies have indicated that pension funds should allocate 20% or more of their assets to real property investments in order to improve their diversification and increase their risk-adjusted return.¹⁹⁶ In spite of their ability to borrow and this optimal allocation, however, pension funds hold between 3.5%–4% of their assets in real property.¹⁹⁷ Although other tax-

¹⁹² See *supra* notes 162, 165–68 and accompanying text.

¹⁹³ See I.R.C. § 514(c)(9)(A) (2006); McDowell, *supra* note 45, at 714.

¹⁹⁴ McDowell, *supra* note 45, at 714.

¹⁹⁵ *Id.* at 714–15.

¹⁹⁶ See Brian A. Ciochetti et al., *Determinants of Real Estate Asset Allocations in Private and Public Pension Plans*, 19 J. REAL ESTATE FIN. & ECON. 193, 193 (1999); Richard M. Ennis & Paul Burik, *Pension Fund Real Estate Investment Under a Simple Equilibrium Pricing Model*, FIN. ANALYSTS J., May/June 1991, at 20, 20.

¹⁹⁷ See *supra* note 196.

exempt entities may act differently than pension funds, it appears unlikely that removing their constraint on borrowing will cause tax-exempt entities to acquire a significant portion of the U.S. real estate market.

In theory, tax-exempt entities could pay higher prices for investment assets than similarly situated taxable investors. A tax-exempt entity can afford to pay a higher price because it can purchase assets with untaxed money. Assume, for example, that a tax-exempt entity and a taxable corporation both want to purchase the same asset. Assume further that each earns \$100 with which to buy the asset. The taxable corporation has to pay taxes on the \$100 and is left with \$65 of after-tax income. As such, the most the taxable corporation can pay for the asset is \$65. The tax-exempt entity, on the other hand, can bid up to \$100 for the same asset. The ability of a tax-exempt entity to outbid taxable persons, however, derives from the tax-exempt entity's exemption from tax, not from its ability to borrow money.¹⁹⁸ Unless the existence of a tax exemption is offensive, the ability to borrow does not create any additional pricing unfairness that the unrelated debt-financed income rules prevent.

Finally, Congress never explicitly endorsed the Treasury Department's concern that leveraged investments would allow tax-exempt entities to eschew public support.¹⁹⁹ Even assuming that Congress shares this concern, however, such a concern is unfounded. Tax-exempt entities already earn significant returns through leveraged, albeit offshore, investment funds.²⁰⁰ Moreover, tax-exempt entities have a wide range of available investments that offer effectively leveraged returns without creating unrelated debt-financed income.²⁰¹ In spite of their ability to earn leveraged returns, tax-exempt entities' investment income has stayed remarkably steady, while the contributions they receive from the public have increased significantly.²⁰² It appears from the historical data that the availability of leveraged returns

¹⁹⁸ McDowell, *supra* note 45, at 733 ("Taxation of all income from debt-financed-investment property would be desirable if borrowing would give tax-exempt investors an advantage over taxable investors that would enable tax-exempt investors to pay a higher price for an asset No such advantage results from the mere act of borrowing.").

¹⁹⁹ *Id.* at 726–27 ("Congress has never expressly embraced the Treasury Department's argument that income from debt-financed property should be taxed so that charities will seek growth through public support instead of leveraged investments.").

²⁰⁰ *See, e.g.,* Cauble, *supra* note 53, at 698–99 ("Educational endowments . . . private employer-sponsored pension plans, and other tax-exempt organizations . . . invest billions of dollars in hedge funds, real estate funds, and private equity funds.").

²⁰¹ *See supra* notes 102–18 and accompanying text.

²⁰² In fact, between 1985 and 2004, public charities' investment income rose from \$21.9 billion (in 2004 dollars) to \$27.8 billion; in the same time period, the contributions, gifts, and grants received by public charities rose from \$87.6 billion (in 2004 dollars) to \$248.6 billion. Paul Arnsberger et al., *A History of the Tax-Exempt Sector: An SOI Perspective*, STAT. INCOME BULL., Winter 2008, at 105, 128, available at <http://www.irs.gov/pub/irs-soi/08winbul.pdf>. In other words, in 1985, the ratio of public charities' revenue from contributions, gifts, and grants to their revenue from investment income was 4:1. By 2004, that ratio had increased to about 9:1.

does not cause tax-exempt entities to quit relying principally on public contributions for their operating revenue.²⁰³

2. *Tax Avoidance.*—Although the unfair-business-practice justifications for the unrelated debt-financed income rules seem inapplicable, the rules were also justified on tax-avoidance grounds. As has been discussed, although the rules are aimed at tax-exempt entities, Congress was not concerned about tax-exempt entities avoiding taxes.²⁰⁴ By granting them an exemption, Congress made clear that it intended for tax-exempt entities to generally remain outside of the reach of the income tax.

Instead, Congress was trying to prevent tax-exempt entities from facilitating taxable persons' tax avoidance. And, unlike the unfair business practices area, leverage is related to tax avoidance. The transactions facilitated by tax-exempt entities generally have little, if any, actual economics. The taxable person is not interested in the investment. Instead, it wants to be able to transfer the incidence of tax that it should pay to an "accommodation party" that is indifferent to that tax.²⁰⁵ Likewise, the tax-exempt entity does not want the risk and reward of an actual investment. Instead, it wants to earn the fee offered by the taxable person. Because there is little chance of a pretax profit, these transactions would not occur in a world without tax. But in a world with taxes, the arbitrage opportunity gives these riskless transactions real value.²⁰⁶

Borrowing makes these riskless transactions possible.²⁰⁷ If, in the sale–leaseback transaction, the tax-exempt entity had to spend its own money, it

²⁰³ Note, too, that in every year, the amount of "program service revenue" earned by public charities dwarfed both the contributions they received and their investment income. *Id.*

²⁰⁴ See *supra* notes 189–90 and accompanying text.

²⁰⁵ It is worth noting that "there [is] no special connection between leasebacks, bootstraps, and charities. The promoters were looking for tax-indifferent counterparties and the comprehensive and permanent nature of the charitable tax exemption served that purpose." Stone, *supra* note 40, at 1519.

²⁰⁶ This is essentially the definition of a tax shelter: "[a] deal done by very smart people that, absent tax considerations, would be very stupid." Tom Herman, *IRS Setbacks in Court Rekindle Debate About Need for Tax-Shelter Legislation*, WALL ST. J., Jan. 7, 2002, at A2 (quoting Professor Michael Graetz).

²⁰⁷ It turns out that these leveraged transactions in which tax-indifferent parties make their exemption available to reduce a taxable person's tax liability are not entirely riskless. Many transit agencies had entered into sale-in-lease-out or lease-in-lease-out transactions in which the transit authorities sold or leased their equipment to taxable persons who, in turn, leased the equipment back to the transit authorities while taking depreciation deductions that the transit authorities could not take. Many of the deals were backed by American International Group, Inc., which collapsed in the credit crisis of 2008, causing the transit authorities to go into technical default and potentially crippling them financially. See Sam Goldfarb, *Auto Bailout with Controversial Tax Provisions Dies in Senate*, 121 TAX NOTES 1222, 1222 (2008). And in some cases, the risk went beyond financial risk. In 2009, a fatal Metro crash occurred in Washington, D.C. Jesse Drucker & Christopher Conkey, *Tax Shelters Slowed D.C. Metro Upgrade*, WALL ST. J., June 26, 2009, at A6. Investigators said that the victims would have had a better chance of surviving if they had been riding newer trains. *Id.* The Washington Metropolitan Area Transit Authority did not replace some of its older trains, however, because it was "constrained by tax advantage [sic] leases" it had entered into to allow taxable persons to take depreciation deductions. *Id.* (quoting the Washington Metropolitan Area Transit Authority).

would face the risk that its counterparty would be unable (or unwilling) to make lease payments and the risk that it would be unable to dispose of the asset it had purchased and leased back at a reasonable price. But to the extent the tax-exempt entity funds most or all of the purchase price by taking out a nonrecourse loan, with interest payments at a rate lower than the lease payments it receives, the tax-exempt entity has no disincentive to facilitate taxable persons' tax avoidance. Instead, it has an economic incentive to facilitate the avoidance.

If the unrelated debt-financed income rules disappeared, tax-exempt entities would not suddenly start engaging in unfair business practices. They could, however, return to facilitating the tax avoidance the rules were passed to prevent, unless a new anti-tax-avoidance rule was passed.

It is worth reiterating that, notwithstanding the unrelated debt-financed income rules, taxable persons have found ways to use tax-exempt entities' exemptions, so the unrelated debt-financed income rules have not functioned as a silver bullet. The proposal I put forward in this Article should not only successfully prevent tax-exempt entities from engaging again in sale-leaseback transactions while allowing them to make legitimate passive investments through leveraged partnership. It should also provide more protection against other unforeseen transactions whereby taxable persons use tax-exempt entities in order to avoid taxes.

C. Using the Tax Shelter Rules to Prevent Abusive Behavior by Tax-Exempts and Their Counterparties

In order to prevent taxpayers from evading taxes by taking advantage of tax-exempt entities' exemptions, the Treasury Department should expand its definition of "reportable transactions."²⁰⁸ In addition to those transactions that are currently reportable, any transaction by which a tax-exempt entity trades or sells part of its exemption should be treated as a reportable transaction for all parties to the transaction.

In 2004, Congress replaced the old tax shelter rules, which required the registration of tax shelters, with new rules requiring taxpayers to disclose their participation of "reportable transactions."²⁰⁹ "Tax shelters [were] extraordinarily complex and highly aggressive (though usually not patently illegal) transactions designed entirely for the purpose of reducing, and in some cases eliminating, the tax liabilities of large corporate or wealthy

²⁰⁸ Reportable transactions are those that the Treasury regulations require participants to disclose to the IRS as a result of the transactions' potential for tax avoidance or evasions. I.R.C. § 6707A(c)(1) (2006).

²⁰⁹ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 815(a), 118 Stat. 1418, 1581 (2004) (codified at I.R.C. § 6111(a)).

individual taxpayers.²¹⁰ Tax-motivated sale–leaseback arrangements and other “sales” by tax-exempt entities fit comfortably within this definition.

The term “tax shelter” has now been replaced by “reportable transaction,” which includes transactions that the Secretary of Treasury determines have a “potential for tax avoidance or evasion.”²¹¹ Currently, there are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions, and “transactions of interest.”²¹²

The Treasury Department could easily add another category. Although removing the unrelated debt-financed income rules would require legislative action, creating a new category of reportable transaction can be accomplished through the Treasury Department’s authority to promulgate regulations.²¹³ And it may not even require the formal steps that go into promulgating regulations. The IRS can identify what constitutes a listed transaction—itsself a subset of reportable transactions—by issuing a notice “or other form of published guidance.”²¹⁴

In order to prevent the abuses that the unrelated debt-financed income rules were originally enacted to address, the new regulations or other published guidance would have to target transactions that would not happen absent the ability of a taxable person to take advantage of a tax-exempt entity’s exemption for a price. The definition would need to be carefully calibrated; there are legitimate transactions that involve tax-exempt entities and taxable persons. For example, it is possible for a tax-exempt entity to purchase an asset from or sell an asset to a taxable person with no tax-avoidance motive. Moreover, it is possible for one to lease property to the other without intending to evade tax. Any rule that discouraged such non-tax-motivated transactions would be inefficient, adding distortions of the type that the rule is designed to prevent.

Based on the various iterations of sale–leaseback and lease–leaseback transactions that have irked the government, the transactions that should be targeted are those that share three characteristics. First, the tax-exempt entity faces no substantial downside risk. The central concern of the unrelated debt-financed income rules was that tax-exempt entities could borrow substantially all of the money that they invested in the suspect transactions. The no-substantial-downside-risk criterion would target the same class of transactions.

²¹⁰ Kyle D. Logue & Gustavo G. Vettori, *Narrowing the Tax Gap Through Presumptive Taxation*, 2 COLUM. J. TAX L. 100, 103 (2011).

²¹¹ § 6707A(c)(1).

²¹² Treas. Reg. § 1.6011-4(b) (as amended in 2007).

²¹³ I.R.C. § 6707A(c)(1); *see also, e.g.*, Prop. Treas. Reg. § 1.6011-4(b)(7), 72 Fed. Reg. 54,615, 54,617 (Sept. 26, 2007) (adding tax patents to the list of reportable transactions).

²¹⁴ Treas. Reg. § 1.6011-4(b)(2) (as amended in 2007).

Second, the tax-exempt entity should have no significant expected return other than the “fee” received. Fee would be defined by substance, not by form or label. In the sale–leaseback transactions, the targeted fee would be that sliver by which rent payments to the tax-exempt entity exceeded the interest and principal payments made by the tax-exempt entity to the lender. Although not designated a fee, this sliver effectively functions as a flat amount that the tax-exempt entity earns that is not subject to any risk except counterparty risk.

Essentially, these two criteria would treat as suspicious any transaction entered into by tax-exempt entities where there was no material risk and no chance for profit. Tax-exempt entities are not necessarily organized in order to make a profit, however.²¹⁵ A presumption that transactions entered into without a clear profit motive are abusive could discourage risk-averse tax-exempt entities from doing things that would further their purposes but not necessarily expose them to risk or reward. The third criterion would confront that problem: to become a reportable transaction, tax evasion must be a principal purpose for the taxable person’s entering into the transaction.²¹⁶ Though not the sole criterion, demonstrating that the taxable person did, in fact, enjoy a substantial reduction in her taxes as a result of entering into the transaction, especially absent any significant risk or opportunity for gain, may provide prima facie evidence that tax evasion was a principal purpose.²¹⁷

²¹⁵ Some commentators have recently proposed that donors to for-profit charities be permitted to deduct their donations. See Malani & Posner, *supra* note 152, at 2018–20. However, the traditional, and more common, intuition is that there is something sacrosanct about providing this extra subsidy solely to entities that do not have a profit motive. See Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1215 (2010) (“Thus, I argue here that federal law should continue to insist that only true nonprofit organizations should be eligible to receive deductible charitable contributions.”).

²¹⁶ The tax law recognizes the difference between *a* principal purpose and *the* principal purpose. For example, the IRS can disallow the tax benefits of an acquisition where “the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax.” I.R.C. § 269(a). The Senate Report defines “the principal purpose” to mean that “the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose.” S. REP. NO. 78-627, at 59 (1943). The Senate’s rule, which ultimately was enacted, is more stringent than the rule proposed by the House of Representatives, which would have required only that “one of the principal purposes for which such acquisition was made or availed of is the avoidance of Federal income or excess profits tax.” H.R. 3687, 78th Cong. § 129(a) (1943). In this case, there is no reason to limit the scope of the antiabuse rule to only those situations where the single most important purpose is tax avoidance; instead, the effective sale of a tax-exempt entity’s exemption should be a reportable transaction if tax avoidance is one of the principal purposes for entering into the transaction.

²¹⁷ This third criterion is similar to the codified economic substance test. Under the Code, a transaction is only treated as possessing economic substance if it changes the taxpayer’s economic position in a meaningful way and the taxpayer has a substantial non-tax purpose for entering into the transaction. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–68 (amending I.R.C. § 7701(o)). The test I am proposing is slightly different than the economic substance test, especially in its purpose, but a transaction with a tax-exempt entity that would satisfy the economic substance test should generally not be a reportable transaction under the test proposed in this Article.

Moving the prevention of abusive behavior by tax-exempt entities from the unrelated debt-financed income rules to the reportable transaction rules has a number of advantages. It would eliminate the distortions and administrative costs that currently discourage tax-exempt entities from making investments they would otherwise prefer to make. The reportable transaction category proposed in this Article is designed to surgically address the abuses that Congress unsuccessfully attempted to address with the unrelated debt-financed income rules. As such, tax-exempt entities will only be discouraged from entering into transactions that had no purpose outside of the reduction of taxes.²¹⁸ Moreover, the reportable transaction rules are not only administered, but are actually drafted, by the Treasury Department;²¹⁹ should it turn out that they are too broad or that they have an undesired distortive effect, the Treasury Department has flexibility to adjust the rules or carve out transactions that fit within the technical contours of the rule but lack the abusive purpose.²²⁰

In addition, the reportable transaction rules would apply to both the tax-exempt entity *and* its taxable counterparty. Because the unrelated debt-financed income rules do not penalize the taxable person buying the tax exemption, there is nothing to discourage the taxable person from looking for a tax-exempt entity willing to sell access to its exemption.²²¹ The

²¹⁸ Eliminating the unrelated debt-financed income rules would allow tax-exempt entities to invest directly in U.S. investment funds rather than investing through a tax haven corporation. The investment would have both downside risk and upside potential for the tax-exempt organization and therefore would not be a reportable transaction. As such, the demand for tax haven blocker corporations by sympathetic investors would diminish, if not entirely disappear. Congress could then continue to shut down their availability with little, if any, backlash.

²¹⁹ The Treasury Department has broad authority to “prescribe all needful . . . regulations for the enforcement of” the Code. I.R.C. § 7805(a). Moreover, the Secretary of the Treasury is expressly granted authority to determine what constitutes a reportable transaction. *Id.* § 6707A(c)(1). Although the Treasury Department has to provide public notice and permit the public to comment on regulations, 5 U.S.C. § 553(b) (2006), it has relatively little impediment to creating a new category.

There may be even more flexibility if the abusive transaction were designated a “listed transaction.” The Treasury Department has delegated the authority to determine what constitutes a listed transaction to the IRS. Treas. Reg. § 1.6011-4(b)(2) (as amended in 2010). And the IRS is not subject to the public notice and comment rules that apply to Treasury Regulations. Peter A. Lowy & Juan F. Vasquez, Jr., *How Revenue Rulings Are Made, and the Implications of that Process for Judicial Deference*, 101 J. TAX’N 230, 230 (2004).

²²⁰ See H.R. REP. NO. 109-455, at 125 (2006) (Conf. Rep.), *reprinted in* 2006 U.S.C.C.A.N. 234, 321 (“Present law authorizes the Secretary to define a reportable transaction on the basis of such transaction being of a type which the Secretary determines as having a potential for tax avoidance or evasion.”).

²²¹ See *supra* notes 189–91 and accompanying text. Moreover, because the only penalty to a tax-exempt entity is that it pays taxes on a portion of its income, if the tax savings were sufficiently large for the taxable person, it may be willing to pay a slightly higher fee in order to compensate the tax-exempt entity both for the use of its exemption and for any taxes paid. In such a case, the unrelated debt-financed income rules would not serve any prophylactic role.

reportable transaction rules, on the other hand, impose disclosure requirements and potential penalties on all parties to a transaction.

The reportable transaction rules require all participants in a reportable transaction to include a disclosure statement with their tax returns.²²² In order to meet the disclosure requirement, information provided by the participants in the reportable transaction must, among other things, describe “the expected tax treatment and all potential tax benefits expected to result from the transaction” in sufficient detail such that the IRS can understand the tax structure and the identity of all of the parties to the transaction.²²³ The penalty for failing to file this disclosure is 75% of the decrease in tax shown as a result of the transaction.²²⁴ In the case of any reportable transaction other than a listed transaction, the penalty imposed on a corporation or other entity is capped at \$50,000.²²⁵ If a corporate participant fails to report a listed transaction, the penalty is capped at \$200,000.²²⁶

In addition to the penalties for failure to disclose reportable transactions, the taxable counterparty faces additional penalties if he understates his income. In general, taxpayers face a penalty of 20% of the amount of an understatement of income tax where that understatement was substantial.²²⁷ In order to be “substantial,” a corporation’s understated income tax must exceed the lesser of 10% of the tax required to be shown or \$10 million.²²⁸ There is no substantiality requirement if the underpayment results from a reportable transaction, however. A 20% penalty is imposed on any reportable transaction understatement that was properly disclosed, irrespective of the size of the understatement.²²⁹ The penalty increases to 30% if the reportable transaction was not disclosed.²³⁰

Tax-exempt entities generally do not have to worry about these understatement penalties. Because they generally have no income tax

²²² Treas. Reg. § 1.6011-4(a). The Treasury Regulations define “participation” separately for each type of reportable transaction. In general, however, “participation” means that a taxpayer’s tax return reflects a tax benefit from the transaction. *Id.* § 1.6011-4(c)(3)(1). In the new category, the definition of participation would have to be expanded, inasmuch as the tax-exempt entity’s tax return would not reflect any tax benefit. However, for transactions of interest, a taxpayer participates “if the taxpayer is one of the types or classes of persons identified as participants in the transaction in the published guidance describing the transaction of interest.” *Id.* § 1.6011-4(c)(3)(i)(E). The new category of reportable transaction would need to define participation with reference to either standard.

²²³ *Id.* § 1.6011-4(d).

²²⁴ Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2041(a), 124 Stat. 2504, 2560 (amending I.R.C. § 6707A(b)(1)).

²²⁵ *Id.* (amending § 6707A(b)(2)(B)). The penalty is capped at \$10,000 for an individual. *Id.*

²²⁶ *Id.* (amending § 6707A(b)(2)(A)). This penalty is capped at \$100,000 for an individual. *Id.*

²²⁷ § 6662(a).

²²⁸ *Id.* § 6662(d)(1)(B). If the taxpayer were not a corporation, the penalty would apply if the understatement exceeded the greater of \$5000 or 10% of the tax required to be shown. *Id.* § 6662(d)(1)(A).

²²⁹ *Id.* § 6662A(a).

²³⁰ *Id.* § 6662A(c).

liability, they are not in a position to understate their liability. The government claims that its “strategy of specifically labeling promoted tax shelter transactions as deviant behavior has apparently effectively translated into an anti-tax-shelter-compliance norm.”²³¹ On the other hand, disclosure alone may not provide sufficient disincentive to prevent tax-exempt entities from becoming counterparties to abusive transactions.²³² Congress appears to have recognized that as long as tax-exempt entities do not suffer economic harm from facilitating abusive tax behavior, there is a chance that they will enter into these abusive transactions. In order to prevent “tax shelters [that] depend on the existence of a seller with an exemption from the tax consequences that would otherwise occur,” it is necessary that “those tax consequences [be] then resurrected.”²³³

Additionally, Congress has resurrected the tax consequences for certain tax-exempt entities that participate in reportable transactions. In general, tax-exempt entities face penalties if they engage in any “tax shelter transaction,” which is defined as all listed transactions and certain reportable transactions.²³⁴ The amount of the penalty is the greater of the tax that would be due on income from the tax shelter transaction (imposed at the highest rate in effect for corporations) or 75% of the proceeds received by the tax-exempt entity that are attributable to the tax shelter transaction.²³⁵ In addition, a manager of a tax-exempt entity that approves the tax-exempt entity’s participation in a tax shelter transaction or otherwise causes the tax-exempt entity to participate in the tax shelter transaction faces a fine of \$20,000 for each such approval.²³⁶ Moreover, these are strict liability penalties; although the original Senate proposal would have exempted

²³¹ Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Compliance Norm*, 75 *FORDHAM L. REV.* 961, 1003 (2006).

²³² *See id.* (“It is conceivable that government officials might make such claims without adequate evidence, perhaps in order to enhance others’ views of their performance or in order to increase taxpayer compliance by conveying the impression that most taxpayers comply.”) It is possible that, if these tax-avoidance transactions became reportable transactions, the public stigma associated with them would discourage at least some tax-exempt entities from engaging in them. While the government is generally not permitted to disclose identifying information from tax returns, § 6103(a), certain tax annual returns made by tax-exempt entities are made available to the public, § 6104(b). Among the returns required to be made public is the disclosure a tax-exempt entity must make if it becomes party to a reportable transaction. §§ 6104(b), 6033(a)(2). Ultimately, however, the issue of whether public stigma alone would prevent tax-exempt entities from participating in reportable transactions is moot, however, because Congress also imposed penalties on such behavior.

²³³ Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 *SMU L. REV.* 83, 117 (2001).

²³⁴ § 4965(a)(1).

²³⁵ *Id.* § 4965(b)(1)(A). If the transaction becomes a listed transaction after the tax-exempt entity enters into it, the penalty is paid at the same rate, but is imposed only on income received after the transaction is identified as a listed transaction. *Id.* § 4965(b)(1)(A)(i)(II), (ii)(II).

²³⁶ *Id.* § 4965(a)(2), (b)(2).

entities and managers from the penalty if the participation was not willful or had reasonable cause,²³⁷ the final bill removed these exceptions.²³⁸

For these penalties to apply, however, the transactions described in this Section would have to become listed transactions or Congress would have to act. Currently, the definition of “tax shelter transactions” only includes listed transactions, confidential transactions, and transactions with contractual protection.²³⁹ Because this would be a new category of reportable transaction, it would have to be expressly included in the ambit of tax shelter transactions, unless the IRS determined it was a listed transaction.

Repealing the unrelated debt-financed income rules meets the demands of tax efficiency. Without the specter of paying taxes on income they earn through pass-through investment funds, tax-exempt investors will be able to analyze potential investments based on their investment appetite. Their investment decisions will not be altered as a result of tax considerations. By combining this freedom for tax-exempt entities with a new category of reportable transactions to combat tax-exempt entities’ selling the use of exemptions to taxable persons, the government can meet its revenue and justice requirements. The government will be able to enact legislation that limits the usefulness to U.S. taxpayers of tax haven corporations without adversely affecting the tax-exempt entities that were using such corporations for nonabusive purposes.

D. Other Possible Solutions Would Not Be as Effective

There are other ways that the government could address the abuses that arise as a result of tax havens. For example, the IRS arguably does not need the Stop Tax Havens Abuse Act or other anti-tax-haven legislation to go after tax evasion using tax haven corporations. Some commentators have suggested that the newly codified economic substance test should provide the IRS with the tools to go after those who take advantage of offshore blockers.²⁴⁰ Alternatively, Congress could impose taxes on all of a tax-

²³⁷ H.R. REP. NO. 109-455, at 128 (2006) (Conf. Rep.), *reprinted in* 2006 U.S.C.C.A.N. 234, 323 (“The entity level tax does not apply if the entity’s participation is not willful and is due to reasonable cause, except that the willful and reasonable cause exception does not apply to the tax imposed for subsequently listed transactions.”).

²³⁸ *Id.* at 129 (“The conference agreement does not include the provision that the entity level or entity manager tax does not apply if the entity’s participation is not willful and is due to reasonable cause.”). Although Congress ultimately chose a strict liability penalty, it also increases the amount of the penalty where the tax-exempt entity “knew, or had reason to know, a transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction.” § 4965(b)(1)(B).

²³⁹ § 4965(e)(1).

²⁴⁰ See James D. Reardon, *Hedge Funds, ECI, and Economic Substance*, 114 TAX NOTES 789, 789 (2007) (“But what really angers most commentators is that hedge funds, or offshore special purpose entities, get involved in helping U.S. domestic taxpayers avoid U.S. income tax. . . . Those egregious

exempt entity's passive income. However, neither solution is likely to be as effective as the reportable transaction rules are at preventing tax-exempt entities from engaging in abusive transactions while freeing them from the distortive effects of the unrelated debt-financed income rules. Both of the solutions, moreover, would have a deleterious effect on tax-exempt entities, just as treating foreign corporations managed in the United States as U.S. corporations for tax purposes would.

1. Economic Substance.—Under the economic substance rules, the IRS can disregard a transaction unless it both changes a taxpayer's economic position in a meaningful way, disregarding federal income tax effects, and if the taxpayer has a substantial non-tax purpose for entering into the transaction.²⁴¹ How would economic substance address the tax evasion? Presumably, it would allow the IRS to disregard the existence of the blocker corporation and treat shareholders as if they directly owned the blocker's investments.²⁴² However, “[t]he degree of corporate purpose and activity requiring recognition of the corporation as a separate entity is extremely low.”²⁴³ Hedge funds can argue that the offshore hedge fund has a business purpose of raising capital from foreign investors and of avoiding certain U.S. regulations that would apply if the fund were a U.S. corporation.²⁴⁴

Moreover, even assuming that the economic substance rules were to apply, it is unclear how they would solve the problem of tax evasion; they would, however, harm tax-exempt entities. Specifically, if the IRS were to

situations really stand out. Many commentators have found the solution in the form of the codification of the economic substance doctrine.”)

²⁴¹ Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–68 (amending I.R.C. § 7701(o)).

²⁴² Using economic substance considerations, the Tax Court has, in certain cases, disregarded corporations and treated shareholders as if they directly earned the corporation's income. *See, e.g., Jondahl v. Comm'r*, 87 T.C.M. (RIA) 307, 316–17 (2005) (“However, even though a corporation is organized under the laws of a State, we may disregard it for Federal tax purposes if it is no more than a vehicle for tax avoidance and void of a legitimate business purpose.”); *Aldon Homes, Inc. v. Comm'r*, 33 T.C. 582, 604–05 (1959) (“The alphabet corporations were but the mechanical instruments which amplified the tune, the melody and lyrics of which had been composed and written by Aldon, and it was Aldon, through its controlling stockholders, which controlled the tempo and the finale—the distribution of the profits. . . . Considering all the facts and circumstances herein, it is our opinion, and we so hold, that the entire net income derived from the development of Tract 17169 is taxable to the petitioner, Aldon Homes, Inc., under the provisions of section 22(a).”).

²⁴³ *Strong v. Comm'r*, 66 T.C. 12, 24 (1976).

²⁴⁴ For example, a U.S. fund with more than 100 investors may be subject to regulation by the S.E.C. 15 U.S.C. § 80a-3(c)(1) (2006). Even if tax-exempt entities had no non-tax reason for investing through offshore blockers, however, it is not clear that the IRS would attack the blockers as lacking economic substance. Even with the newly codified economic substance rules, “the ability of tax-exempt organizations to avoid debt-financed income by investing through blockers is so universally accepted that it is unlikely the IRS would begin to challenge it.” David S. Miller, *How U.S. Tax Law Encourages Investment Through Tax Havens*, 131 TAX NOTES 167, 185 (2011).

assert that the tax haven blocker should be disregarded, tax-exempt investors would be treated as making leveraged investments either directly or through a master partnership. Either way, a portion of the tax-exempt investor's investment would be treated as unrelated debt-financed income—the result this Article is attempting to avoid.

On the other hand, those avoiding taxes are counting in large part on the anonymity of tax haven investments to hide their money. Merely disregarding the blocker corporation would not suddenly make these invisible investors visible to the IRS. The Stop Tax Haven Abuse Act does not need to strip tax evaders of their anonymity in order to make their evasive behavior less attractive. By treating the blocker corporation as a U.S. corporation, the blocker will be taxable in the United States at ordinary corporate rates, thus reducing the investment return currently enjoyed by evaders and indirectly imposing tax on the evaders even without knowing who they are. But disregarding the blocker corporation does not, in itself, impose any tax (or other penalty) on evaders. In essence, using economic substance would penalize tax-exempt entities, which are not behaving in an abusive manner in any event, without touching tax-evaders. The result, then, would be even worse than enacting the Stop Tax Havens Abuse Act without enacting a fix to the unrelated debt-financed income rules.

2. *Tax All Passive Income.*—As another alternative, Congress could eliminate the tax exemption on all passive income, rather than just passive income earned from a leveraged investment. At one level, taxing all of a tax-exempt entity's passive income would have a similar effect on the entity's investment decisions as exempting all of its passive income from tax: because it would be taxable whether its investment were leveraged or not, a tax-exempt entity would no longer be discouraged from investing in a leveraged partnership.²⁴⁵

Moreover, because taxing all of a tax-exempt entity's taxable income would reduce the after-tax return of their investments, it would likely cause tax-exempt entities to rely more on public contributions and less on investment returns.²⁴⁶ Finally, taxing tax-exempt entities on all of their investment income could discourage them from investing in tax haven blockers even more than would exempting all investment income from tax.²⁴⁷ Not only would tax-exempt entities face the possibility of two levels of taxation on a portion of their income, but they could realistically become subject to the subpart F and PFIC antiabuse rules that currently apply to investments by taxable persons.

Still, taxing tax-exempt entities on all of their investment income is probably an undesirable solution. It flies in the face of Congress's express

²⁴⁵ See *supra* notes 147–49 and accompanying text.

²⁴⁶ See *supra* note 168 and accompanying text.

²⁴⁷ See *supra* notes 179–82 and accompanying text.

policy decision as it created the UBTI: tax-exempt entities' passive income should not be taxable.²⁴⁸ Although Congress may certainly revisit that decision, treating all of a tax-exempt entity's passive income as taxable would radically redefine the meaning of the tax exemption. "[T]axing all investment income earned by at least certain tax-exempt entities could significantly interfere with the purpose of granting their exemption in the first place."²⁴⁹ Before interfering so fundamentally with the tax exemption's purpose, it would be necessary to determine that the social gains outweighed the harms, both to tax-exempt entities and to those who benefit from tax-exempt entities.

CONCLUSION

The unrelated debt-financed income rules have a significant distortive effect on the investments of tax-exempt entities. As a result of these rules, tax-exempts that want to invest in leveraged investment funds generally have to invest through a blocker corporation organized in a tax haven jurisdiction, or they have to pay taxes on their investment income. However, Congress clearly never intended for tax-exempt entities to pay taxes on their investment income. Moreover, the IRS has blessed investment by a tax-exempt entity through offshore blocker corporations as being nonabusive.

Nonetheless, tax havens provide a number of opportunities for taxable U.S. persons to illegitimately and, in many cases, illegally evade taxes. The U.S. government has a legitimate interest in aggressively working to counteract these potential abuses. As long as the unrelated debt-financed income rules remain law, however, any tax legislation that makes tax havens less hospitable to taxable U.S. persons will also harm tax-exempt entities.

This Article has demonstrated that the unrelated debt-financed income rules do not serve any central function in the regulation of tax-exempt entities. Instead, they were intended to prevent taxable persons from using an entity's tax exemption in order to reduce the taxable person's tax liability. But because the unrelated debt-financed income rules solely penalize the tax-exempt entity (that is, the party that benefits less from these transactions), they have been less than completely effective.

If, instead, Congress were to repeal the unrelated debt-financed income rules and expand the reportable transaction rules, it could aggressively address the problems of the abusive use of tax havens without sacrificing the benefits it determined beneficial to grant to tax-exempt entities. By moving to the reportable transactions regime, the IRS would discourage both taxable persons and tax-exempt entities from abusively shifting the

²⁴⁸ See *supra* note 43 and accompanying text.

²⁴⁹ Cauble, *supra* note 53, at 747.

benefits of the tax exemption. Moreover, without tax-exempt entities having a legitimate, nonabusive reason to invest through tax haven blockers, Congress will be free to move as strongly as it deems necessary to create norms and laws that discourage the abuse of tax havens by U.S. taxpayers.