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Testimony Before the
Committee on Finance
United States Senate

Offshore Tax Issues: Reinsurance and Hedge Funds

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Mr. Chairman and Members of the Committee:

My name is Suzanne Ross McDowell. I am a partner in the law firm Steptoe & Johnson LLP in Washington, D.C. My practice focuses on the law of tax-exempt organizations with particular emphasis on tax, corporate governance, and commercial transactions. From 1983 to 1987, I served in the Office of Tax Policy at the U.S. Department of Treasury and was responsible for issues relating to tax-exempt organizations, including issues related to the debt-financed income rules. Since leaving the Treasury Department, I have written academic papers and given presentations on the debt-financed income rules and numerous other topics relevant to tax-exempt organizations.[1] The views I am expressing are my own and do not represent the views of my law firm, any client or any other organization.

My testimony today will focus on the unrelated debt-financed income rules. These rules impose a tax on investment income of an exempt organization that would otherwise be tax-exempt solely because the exempt organization uses debt to acquire the property that produces the income.[2] To avoid the tax imposed by the debt-financed income rules, exempt organizations often use so-called blocker entities to acquire investments. Generally speaking, a blocker entity is a corporate entity formed in a low-tax jurisdiction that is interposed between an investment and the exempt organization. The corporation "blocks" the attribution of any debt to the exempt

organization, and thus enables the exempt organization to avoid the application of the debt-financed income rules. My testimony will cover the history and purpose of the rules, the types of transactions they discourage, and the policy concerns that should be considered by Congress in the course of its evaluation.

Legislative History and Current Law

Tax-Exempt Status of "Passive Income." Since 1950, tax-exempt organizations have been subject to the unrelated business income tax ("UBIT") on income from businesses that are not related to their exempt functions. When Congress enacted the UBIT, it excluded certain types of investment income -- commonly referred to as "passive income"-- from the tax. Specifically, dividends, interest, royalties, annuities, most rents, and capital gains and losses were not subject to UBIT.[3] In the years since the enactment of the UBIT, exceptions have been added for payments with respect to securities loans,[4] loan commitment fees,[5] and income from the lapse or termination of options.[6] According to the legislative history, Congress excluded these types of income from UBIT because it did not think they posed serious competition for taxable businesses and because such income had long been recognized as a proper source of revenue for educational and charitable organizations.[7]

Unrelated Debt-Financed Income Rules. The exclusion for "passive income" does not apply to the extent that such income is derived from debt-financed property.[8] In other words, income earned by an exempt organization from debt-financed property is subject to tax. Property is treated as debt-financed if indebtedness is incurred before or after the acquisition or improvement of the property that would not have been incurred but for such acquisition or improvement.[9] The portion of income that is subject to tax is the fraction equal to the average

acquisition indebtedness for the year over the average adjusted basis of the property for the year.[10]

The debt-financed income rules were passed in 1969 to foreclose abusive sale-leaseback transactions. In such transactions, a charitable organization would acquire property (usually real estate) from a taxable business, often borrowing to finance the entire purchase price. As a condition of the sale, the exempt organization would lease the property back to the seller on a long-term basis. The exempt organization would repay the loan, plus interest, with the lease payments or "rental payments" received from the seller-lessee. The exempt organization would receive both (i) the difference between the "rental payments" and the sale price and (ii) outright title to the property, all without investing or risking much, if any, of its own funds. The seller would obtain capital gain treatment for the sale price received and large deductions against taxable income for the "rental payments" made, all while continuing to operate its business using the property in the same manner as before.[11]

Application of Unrelated Debt-Financed Income Rules to Securities and Financial Products. The debt-financed income rules have been challenging to apply to securities and other financial products. Neither the Internal Revenue Code (the "Code") nor the Treasury regulations thereunder define "indebtedness" for purposes of the debt-financed income rules. Consequently, in determining whether a particular transaction creates indebtedness and therefore is subject to tax, the Internal Revenue Service and the courts have looked to common law definitions of indebtedness and definitions in other parts of the Code. The result has been that the rules have been applied in a formalistic manner. Generally, when a tax-exempt investor borrows funds and has a clear obligation to repay the funds, the debt-financed income rules are applicable. Thus, securities purchased on margin have been held to be debt-financed property.[12]

A pension plan that used a certificate of deposit ("CD") with a low interest rate as collateral to borrow funds to acquire a new CD with a higher interest rate was subject to UBIT on the new CD because it was purchased with borrowed funds.[13] In this case, the pension fund was not seeking to leverage its investment. It simply wanted to avoid incurring penalties for early redemption of the low-interest CD, while at the same time reaping the benefits of an increase in interest rates. Similarly, the withdrawal of the accumulated cash value of life insurance policies for the purpose of investing the funds in property with a higher rate of return has been held to create acquisition indebtedness and, therefore, is unrelated debt-financed income when such withdrawals are used to purchase securities.[14]

In contrast to the above examples, many transactions that do not involve debt in the traditional sense of borrowing funds and incurring an obligation to repay the funds, but do involve leverage, are not subject to the debt-financed property rules. In many cases, because the transactions were not clear cases of borrowing, the IRS relied on Congressional intent to exclude investment income from tax in reaching its conclusion that the debt-financed income rules do not apply. Thus, securities lending transactions,[15] short sales of stock,[16] commodities futures contracts,[17] securities arbitrage transactions[18] and notional principal contracts[19] are not treated as debt-financed property and are not subject to UBIT.

Limited Exception for Real Estate. Income earned from real estate is excluded from the unrelated debt-financed income rules under a limited exception, but only if certain conditions are satisfied.[20] Additionally, the exception only applies to real property acquired by pension trusts, schools, colleges and universities. To qualify for the exception, the real estate transaction cannot have certain characteristics of the sale-leaseback transactions that were the target of the rules when first enacted. Thus, for example, the transaction cannot involve (i) seller financing;

(ii) indebtedness determined by reference to income from the property; or (iii) a lease back to the seller.[21] Additionally, in the case of real estate investments made by partnerships, the exception is limited to transactions that do not permit tax-exempt partners to transfer tax benefits to taxable partners.[22] Certain of these rules that limit the exception for real estate partnerships, most notably the so-called "Fractions Rule," are exceedingly complex and difficult to apply in practice.[23]

"Blocker Entities." The unrelated debt-financed income rules can be avoided on securities and financial products by investing through foreign corporations referred to as "blocker entities." A blocker entity is a foreign corporation usually established in a low tax jurisdiction. The tax-exempt investor invests in the foreign corporation and the foreign corporation in turn invests in a hedge fund or other similar debt-financed investment. Income from the hedge fund or other investment is distributed to the foreign corporation, which pays little or no tax on the income as a result of the jurisdiction in which it is established. The foreign corporation in turn pays the income to the tax-exempt investor as a dividend. Because dividends are not subject to UBIT, the income from the hedge fund is not taxable to the tax-exempt investor and the debt-financed income rules are avoided. Most hedge funds are partnerships and, in the absence of the blocker entity, debt-financed income would be passed through to the tax-exempt investor as debt-financed income and would be subject to tax.[24] The Service has issued private letter rulings upholding the treatment of income received from a foreign corporation used as a blocker entity as a dividend that is not subject to UBIT.[25]

Other Ways to Avoid Debt-Financed Income. Blocker entities are not the only way to avoid the unrelated debt-financed income rules. The unrelated debt-financed income rules can also be avoided through contractual arrangements. In private letter rulings, the Service has held

charitable remainder trusts did not have unrelated debt-financed income when they had a contractual right to income based on an educational institution's endowment even though the endowment had some unrelated debt-financed income. The educational institution, which was the charitable beneficiary of the trust entered into a contract with the trust giving it a right "units" that were tied to the value of the institution's endowment. The units entitled the charitable remainder trust to periodic income equal to the payout rate of the institution's endowment and the units could be redeemed for amounts based on the value of the endowment.[26]

Additionally, the unrelated debt-financed income rules do not apply to an investment in a mutual fund that purchases securities and financial products that would be treated as debt-financed property if purchased directly by the exempt organization or through a partnership. Similarly, investment in debt-financed property through a real estate investment trust ("REIT") generally does not result in income subject to UBIT.[27] In addition, investment through a variable contract with an insurance company tied to a segregated asset account that includes investments that would be treated as debt-financed property if purchased directly by the exempt organization or by a partnership in which the exempt organization is a partner is generally not subject to UBIT.[28]

Discussion

At first blush, blocker entities may appear to be a "loophole" that should be shut down. However, blocker entities are frequently used to avoid the application of the unrelated debt-financed income rules to transactions that were never intended to be within the scope of the rules. Thus, before taking action on blocker entities, Congress should re-evaluate the policy and impact of the unrelated debt-financed income rules.[29]

The unrelated debt-financed income rules tax all debt-financed investments of tax-exempt organizations, although they were enacted to foreclose abusive sale leaseback transactions. The current breadth of application would be justified only if all leveraged investments of tax-exempt investors should be discouraged. The purpose of leverage is to increase the investor's return on investment. The trade-off for the increased return is taking on greater risk.[30] The increased risk of an individual investment, however, can be reduced through diversification in the investor's portfolio and by hedging. Furthermore, investments that do not use leverage may be as risky or riskier than leveraged investments. Thus, taxing all debt-financed income is not an effective way to protect tax-exempt investors from risk.

Moreover, the level of risk assumed by tax-exempt organizations is already addressed by various other laws that create legal standards for permissible investments of tax-exempt organizations. At the federal level, investments of private foundations are subject to the jeopardizing investment rules of Code section 4944 and pension funds are subject to the fiduciary standards of ERISA.[31] At the state level, directors of nonprofit corporations must adhere to the common law duties of care and loyalty. Additionally, most states have adopted the Uniform Management of Institutional Funds Act (UMIFA), which provides uniform rules governing the investment of endowment funds held by charitable institutions.[32] UMIFA was approved by the National Conference of Commissioners on Uniform States Laws (NCCUSL) in 1972, and established a standard of business care and prudence in the context of the operation of a charitable institution. Prior to UMIFA, each investment of a charitable institution was evaluated separately, an approach that led directors of charities to feel compelled to limit investments to fixed income investments and dividend-paying stocks. UMIFA changed the law to permit an approach that is more in line with modern portfolio management theories, looking at

the portfolio as a whole rather than investment by investment.[33] In 2006, the NCCUSL further modernized the standards applicable to charitable institution fund management and approved a revision of UMIFA entitled the Uniform Prudent Management of Institutional Funds Act (UPMIFA).[34] UPMIFA expanded the application of UMIFA to charitable trusts and incorporated the more modern standards of the Uniform Prudent Investor Act passed by NCCUSL in 1994. UPMIFA provides that, "[m]anagement and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution."[35]

In summary, debt financing increases the risk of an individual transaction, but that is not a reason to discourage all debt financing without regard to the level of risk and return of a charitable institution's investments as a whole, as the debt-financed income rules do. Moreover, the debt-financed income rules are unnecessary for this purpose because other laws govern investment standards with a more nuanced and aggregate approach that is consistent with modern investment theory.

An additional problem with the debt-financed income rules is that they have been applied in a rigid manner that makes formalistic distinctions between debt and leverage. As described above, the result is that the rules tax transactions which involve direct borrowing while permitting investors who use leverage in more sophisticated transactions to escape tax.

Recommendations

Rather than focusing on the use of blocker entities to avoid the unrelated debt-financed income rules, I urge Congress to evaluate the operation of the debt-financed income rules and to significantly restrict the application of these rules. Under current law, there is an exception for

real estate transactions of pension funds and universities if the transactions meet certain requirements. This exception, and its requirements, should be used as the model for a broader exception applicable to all types of debt-financed property and available to all tax-exempt organizations.

First, the exception should not be limited to pension funds and universities. While some tax policy argument may exist that pension trusts are uniquely focused solely on investments and are therefore distinct from other exempt organizations, a similar argument cannot be made to distinguish colleges and universities from other tax-exempt organizations. Therefore, exceptions to the debt-financed income rules should apply to all tax-exempt organizations.

Further, the exception should not be limited to real estate. As discussed above, the current debt-financed income rules apply to many legitimate investment transactions that are not abusive and were not the intended target of the rules. The current real estate exception includes requirements that (i) the indebtedness be for a fixed amount; (ii) the seller not provide financing; and (iii) the lender not have the use of the property. These requirements should be retained as a condition to a new broader exception that applies to all debt-financed property.

Finally, the current real estate exception includes restrictions applicable to investments made through partnerships which are intended to prevent the transfer of tax benefits from tax-exempt partners to taxable partners. These restrictions are tailored to real estate transactions and do not lend themselves to application to investments in other property such as securities and other financial products. Although I am not aware of hedge funds and other investment partnerships being used to transfer tax benefits from tax-exempt partners to taxable partners, nevertheless, Congress should give the Treasury authority to promulgate regulations in the future if necessary to foreclose such transfers in non-real estate partnerships.

Conclusion

If Congress amends the unrelated debt-financed income rules as suggested, tax-exempt investors would no longer be forced to invest offshore and use blocker entities to avoid the unrelated debt-financed income rules on legitimate investments. Further, the current disparate treatment between direct borrowing and leverage, and between different types of tax-exempt investors, would be eliminated.

I would be pleased to respond to your questions.

Endnotes

[1] *Taxing Leverage Investments of Charitable Organizations: What is the Rationale?,* 39 Case W. Res. L. Rev. 705 (1988); *Taxation of Unrelated Debt-Financed Income*, 34 Exempt Org. Tax Rev. 197 (2001).

[2] IRC § 512(b)(4); 514(a)(1).

[3] IRC §§ 512(b)(1), (2), (3), (5).

[4] IRC § 512(b)(1), (a)(5).

[5] IRC § 512(b)(1).

[6] IRC § 512(b)(5).

[7] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-40 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31, (1950).

[8] Section 514 applies to all debt-financed property but contains several exceptions which have the collective effect of generally limiting its application to investment income. See §§ IRC 514(b)(1)A) - (E), 514(b)(3); 514(c)(2), (4), (5), (6), (8).

[9] IRC § 514(c)(1).

[10] IRC § 514(a)(1).

[11] S. Rep. No. 552, 91st Cong., 1st Sess. 62-63, *reprinted in* 1969 U.S.C.C.A.N. 2027, 2091-92; H.R. Rep. No. 413, 91st Cong., 1st Sess. 44-46, *reprinted in* 1969 U.S.C.C.A.N. 1645, 1690-91.

[12] *See*, *e.g.*, *Elliott Knitwear Profit Sharing Plan v. Comm'r*, 614 F.2d 347 (3d Cir. 1980), *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (N.D. Ala. 1986); *Ocean Cove Corporation Retirement Plan v. United States*, 657 F. Supp. 776 (S.D. Fla. 1987); *Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*, 209 F.3d 147, 156 (2d Cir. 2000).

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[13] *See Kern County Electrical Pension Fund v. Comm'r*, 96 T.C. 845 (1991).

[14] *Mose & Garrison Siskind Memorial Foundation Foundation v. United States*, 790 F.2d 480 (6th Cir. 1986).

[15] Rev. Rul. 78-88, 1978-1 CB 163.

[16] Rev. Rul. 95-8, 1995-1 CB 107. *See also* PLR 9637053 (Sept. 13, 1996); PLR 9703027 (Jan. 17, 1997).

[17] Gen. Couns. Mem. 39620 (April 3, 1987).
[18] Gen. Couns. Mem. 39615 (March 23, 1987).

[19] Treas. Reg. § 1.512(b)-1(a)(1).

[20] IRC § 514(c)(9).

[21] IRC § 514(c)(9)(B)(i)-(v).

[22] IRC § 514(c)(9)(B)(i)-(v).

[23] IRC § 514(c)(9)(E).

[24] IRC § 512(c).

[25] Priv. Ltr. Rul. 199952086 (Sept. 30, 1999).

[26] *See* Priv. Ltr. Rul. 200352017 (Oct. 3. 2003); Priv. Ltr. Rul. 200352018 (Oct. 3, 2003); Priv. Ltr. Rul. 200703037(Oct. 23, 2006); Priv. Ltr. Rul. 200703038 (Oct. 23, 2006). The Service also ruled that a charitable lead trust could avoid unrelated debt-financed income through a similar contractual arrangement but later limited the application of the ruling to funds that had already been invested in the endowment through the contractual arrangement. *See* Priv. Ltr. Rul. 200352019 (granting ruling to charitable lead trust); Priv. Ltr. Rul. 200702036 (Oct. 17, 2006) (limiting the application of Priv. Ltr. Rul. 200352019). The clarifying ruling indicated that the Service is concerned about inappropriate benefits to non-charitable beneficiaries because in a charitable lead trust, the charity receives the income for a term of years and then a non-charitable beneficiary receives the remainder interest. The Service stated that it is studying whether a charitable lead trust should realize UBIT on the transaction.

[27] Note, however, that by definition a REIT must have 100 or more shareholders, a requirement that makes a REIT a less attractive alternative investment vehicle. In addition, section 856(h)(3)(C) recharacterizes dividends from a REIT in certain circumstances on a look-through basis if the REIT is "predominantly held by qualified trusts."

[28] Note, however, that if the segregated asset account is not adequately diversified within the meaning of section 817(h), certain look-through rules apply and may result in UBIT.

[29] In the 1980s, blocker entities were used to avoid UBIT on offshore captive insurance companies. *See* Priv. Ltr. Rul. 8819034 (Feb. 10, 1988). In response, Congress added Section 512(b)(17)(A) to the Code, providing that foreign source income from offshore captive insurance companies is taxable. Small Business Job Protection Act of 1996, Pub. L. 104-188, section 1603(a). Those cases, however, involved the operation of an active unrelated business—an activity that the UBIT is clearly intended to tax.

[30] For example, if an investor buys $100,000 worth of stock and the value of the stock increases by 10 percent in one year, the investor has earned $10,000. If this same investor borrowed another $100,000 at 8-percent interest and invested $200,000 in the same stock, it

would earn $20,000 on the stock and, after paying $8,000 in interest on its debt, would net $12,000, an increase in its rate of return from 10 percent to 12 percent. Of course, if the $200,000 in stock did not earn at least $8,000 to cover the interest payment, the investor would have a loss. Thus, the leveraged investment is riskier because the return on the investment must be at least 4 percent for the investor to avoid a loss.

[31] Employee Retirement Income Security Act, Section 404 29 U.S. C. 1104.

[32] According to the NCCUSL, UMIFA has been adopted in 47 states.

[33] When originally passed, UMIFA did not apply to charitable trusts. In 1992, the *Restatement (Third) of Trusts* adopted standards similar to UMIFA and reformulated the Prudent Man Rule to provide that borrowing is permissible if the tactic is "employed selectively and cautiously." *See* Restatement (Third) of Trusts (The Prudent Investor Rule), § 227 (1992). Two years later, the NCCSL approved the Uniform Prudent Investor Act and incorporated the principles of the Restatement and principles of modern portfolio management. As described above, these standards were further incorporated into UPMIFA in 2006.

[34] According to NCCUSL, UPMIFA has already been adopted by 13 states.

[35] UPMIFA § 3(e)(2).