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Unfair and Unintended: The Tax-Exempt Organization Blocker Loophole

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Unfair and Unintended: The Tax-Exempt Organization Blocker Loophole

I. INTRODUCTION

Politicians love to attack the Internal Revenue Code (the "Code"). Arguably, it is too long, too complicated, and full of loopholes that benefit the wealthy. Even tax lawyers and certified public accountants who have devoted their professional lives to studying tax law and tax accounting cannot easily understand the Code's complexity. Indeed, even judges, whom society esteems to be the final authority on all things legal, have an extraordinarily difficult time parsing the Code's complicated terminology. While referring to a particular Subchapter K Code section, one judge famously stated, "Surely, a statute has not achieved 'simplicity' when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries."[1]

Some of the Code's greatest "mysteries" live in the world of international taxation. The Code is full of complicated tax rules for various types of entities, including tax-exempt organizations, which earn income abroad. The Code is littered with loopholes. In addition to the potential lost revenue from legally exploited loopholes, an IRS consultant estimated that the United States Treasury loses $70 billion annually in revenue due to offshore tax evasion.[2]

Tax-exempt organizations are able to use the foreign blocker corporation loophole in conjunction with their hedge fund investments to decrease their potential tax liability. This Comment argues that tax-exempt organizations should not be able to receive tax-free dividends from foreign blocker corporations that invest in hedge funds for three reasons: (1) the blocker corporation is an unintended consequence of the unrelated business taxable income ("UBTI") rules; (2) the blocker corporation structure fails a substance over form analysis; and (3) closing the loophole will provide increased revenue to the United States Treasury.

1. Foxman v. Comm'r, 41 T.C. 535, 551 n.9 (1964).

2. Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 NW. U. L. REV. 225, 227 n.7 (2012).

This Comment is divided into several parts. Part II discusses tax-exempt organizations and their relation to hedge funds. Part III discusses the foreign blocker corporation and passive foreign investment companies ("PFICs"). Part IV discusses the reasons why Congress should close the blocker loophole. Part V provides several suggestions on how the loophole might be wholly or partially closed: (1) amending the § 1291 PFIC rules; (2) amending the § 512 UBTI exceptions; (3) increasing the § 4940 and § 4944 taxes on private foundations; and (4) applying the § 4940 and § 4944 proposed changes to all tax-exempt organizations by amending § 509. Part VI concludes.

II. TAX-EXEMPT ORGANIZATIONS AND HEDGE FUNDS

A. Tax-Exempt Organizations in a Nutshell

Generally, if an organization meets the requirements of a tax-exempt organization under § 501 of the Code, then it will be exempt from federal income tax.[3] The most famous tax-exempt organizations are § 501(c)(3) organizations, which include public charities (e.g., the Red Cross), operating foundations, and private foundations (e.g., the Bill & Melinda Gates Foundation).[4] All § 501(c)(3) organizations are exempt from federal income tax,[5] and a donor's contribution to a § 501(c)(3) organization can be deducted from the donor's federal tax liability.[6]

Although data is extremely limited regarding which tax-exempt organizations use the foreign blocker corporation loophole, due to the costs associated with complex tax structuring, there is good reason to believe that many asset-rich, tax-exempt organizations utilize the blocker corporation scheme, including public charities, university endowments, churches, and private foundations.[7]

3. I.R.C. § 501 (2012).

4. *See id.* § 501(c)(3).

5. *Id.* § 501(a).

6. *Id.* § 170(a).

7. *See* STAFF OF THE JOINT COMM. ON TAX'N, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II (Comm. Print 2007) [hereinafter TAX TREATMENT II].

B. The Taxation of Tax-Exempt Organizations

1. UBTI

In 1950, Congress passed rules that imposed a tax on a tax-exempt organization's unrelated business income.[8] Before the rules were created, some tax-exempt organizations started to look too commercial in nature, and the government feared that tax-exempt organizations could distort the market by selling goods at a below-market price while still obtaining a market rate of return due to their tax-exemption.[9] Under the Revenue Act of 1950, Congress passed rules that placed an income tax on any part of a tax-exempt organization's income that met the following requirements: (1) income received was from a trade or business; (2) the trade or business was "regularly carried on" by the tax-exempt organization; and (3) the trade or business was not "substantially related" to the tax-exempt organization's purpose (income that met these requirements is referred to as unrelated business taxable income or UBTI).[10] Certain exceptions were included in the UBTI Rules. For example, dividends, interest, royalties, and other passive types of income were exempt from the UBTI regime.[11]

In the Tax Reform Act of 1969, Congress passed more comprehensive rules relating to debt-financed income and indicated that interest, dividends, rents, royalties, and certain other types of payments from debt-financed transactions unrelated to a tax-exempt organization's purpose would also be taxed as UBTI.[12] The provisions targeting debt-financed income were primarily aimed at

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8. *See* Brunson, *supra* note 2, at 230.

9. *Id.*

10. *See* I.R.C. §§ 511–13 (2012).

11. *Id.* § 512(b). Additionally, there are other exceptions to the UBTI rules, but those exceptions are inapplicable to this Comment.

> Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions.

TAX TREATMENT II, *supra* note 7, at 10–11.

12. *See* Brunson, *supra* note 2, at 232–35.

stopping sale-leaseback transactions, which allowed tax-exempt organizations to use their tax-exempt status to distort the market in ways other than selling goods at a below-market price for a market rate of return. For example, in a typical sale-leaseback transaction, a tax-exempt organization would borrow money to finance a real or personal property purchase from a private individual or company.[13] The seller would normally pay a long-term capital gain tax on the sale, and the tax-exempt organization would then rent the property back to the seller. Under this scheme, tax-exempt organizations were able to charge a below-market rent price to the seller but still receive a fair market rental payment because the rental income was not taxable under the UBTI exceptions prior to 1969.[14]

After the Tax Reform Act of 1969, the exceptions to UBTI, including those for dividends, interest payments, and royalties, were not allowed if the income was derived from a debt-financed investment, otherwise known as a leveraged investment.[15]

2. Excise taxes

In addition to the UBTI regime, some tax-exempt organizations are also subject to excise taxes. Currently, tax-exempt private foundations are subject to a 2% excise tax on their investment income under § 4940(a) of the Code. Section 4940(a) reads:

> There is hereby imposed on each private foundation which is exempt from taxation under section 501(a) [26 U.S.C. § 501(a)] for the taxable year, with respect to the carrying on its activities, a tax equal to 2 percent of the net investment income of such foundation for the taxable year.[16]

In determining a private foundation's net investment income for the current taxable year, the IRS considers the foundation's income from interest, dividends, rents, and other passive income sources.[17]

13. *See, e.g.*, Comm'r v. Brown, 380 U.S. 565 (1965) (involving a sale-leaseback transaction dealing with tangible property).

14. STAFF OF THE JOINT COMM. ON TAX'N, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO SELECTED INTERNATIONAL TAX ISSUES 46–47 (Comm. Print 2007) [hereinafter SELECTED INTERNATIONAL TAX ISSUES].

15. *See* TAX TREATMENT II, *supra* note 7, at 10–11.

16. I.R.C. § 4940(a) (2012).

17. *See* I.R.S. Ruling, IRM 7.27.14.4 (Feb. 26, 1999), *available at* http://www.irs.gov/irm/part7/irm_07-027-014.html.

Additionally, § 4944 of the Code imposes a 10% tax on investments that may jeopardize a private foundation's tax-exempt purpose. The statute reads:

> If a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, there is hereby imposed on the making of such investment a tax equal to 10 percent of the amount so invested for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by the private foundation.[18]

The Treasury Regulations ("Regulations") imply that foundation managers have great discretion regarding the transactions their private foundations engage in, and a transaction is only considered "jeopardizing" to the foundation if it is made without ordinary business care. The Regulations state that a transaction is jeopardizing if

> it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.[19]

As the law currently stands, all tax-exempt organizations are subject to the UBTI regime, but only private foundations are subject to excise taxes.[20]

C. Tax-Exempt Organizations as Domestic Hedge Fund Investors

1. Hedge funds in a nutshell

Hedge funds are large funds that invest primarily in liquid securities and other assets. They are "actively managed investments that pool investors' capital in order to acquire, own, and trade one or more of securities, commodities, and financial products."[21] Hedge fund investors have generally been one of three types: "high net-worth individuals who are subject to U.S. tax; foreign persons who

18. I.R.C. § 4944(a)(1).
19. 26 C.F.R. § 53.4944-1 (2013).
20. *See* I.R.C. § 4944(a)(1).
21. Brunson, *supra* note 2, at 236.

are not otherwise subject to U.S. tax; and U.S. institutional investors (such as charities and private and government pension funds) that are tax-exempt under U.S. tax rules."[22]

As of 2006, almost 55% of worldwide hedge funds were registered offshore, meaning that the funds were registered in different countries from where the fund was based.[23] Nearly all of the offshore funds, 92%, were registered in low-tax jurisdictions, including the Cayman Islands, the British Virgin Islands, Bermuda, and the Bahamas.[24] Of the remaining worldwide hedge funds, 48% were registered in the United States, mostly in Delaware.[25]

2. Taxation of passed-through profits from hedge funds

In the United States, hedge funds are typically taxed as partnerships under federal income tax law.[26] When a hedge fund is structured as a partnership, the fund's profits and losses are passed through to its members or investors.[27] Under the UBTI rules, income passed through from the hedge fund to the tax-exempt organization will likely be UBTI because it will be income received from a trade or business that is not "substantially related" to the tax-exempt organization's purpose and is "regularly carried on" by the tax-exempt organization.[28] Even if all the income is not classified as UBTI, then at least the portion of the profits that result from leveraged investments will be taxed as UBTI.[29]

The diagram below shows a simplified version of how a tax-exempt organization invests in a hedge fund.

22. TAX TREATMENT II, *supra* note 7, at 2.

23. *Id.* at 8.

24. *Id.*

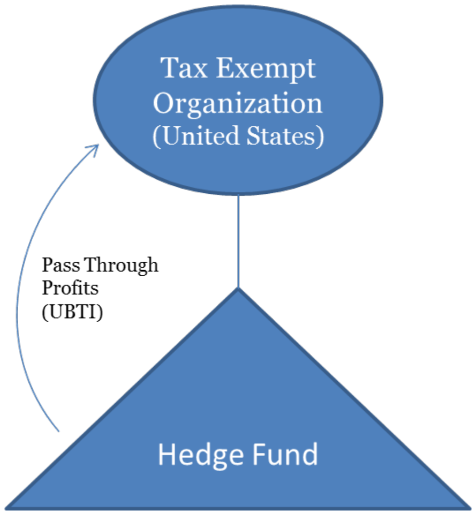
25. *Id.*

26. *See* INVESTORS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP OF FINANCIAL MATTERS, PRINCIPLES AND BEST PRACTICES FOR HEDGE FUND INVESTORS 41 (2009) [hereinafter PRINCIPLES AND BEST PRACTICES].

27. *Id.*

28. See I.R.C. §§ 511–13 (2012).

29. *See* Brunson, *supra* note 2, at 230–31; *see also* I.R.C. § 514(a).



Since profits from hedge funds will almost certainly trigger UBTI, a tax-exempt organization uses the blocker corporation loophole to earn a tax-free return on its investment.

III. Blocker Corporations and Passive Foreign Investment Companies

A. Taxing Corporations in General

Unlike partnerships, corporations do not pass through profits and losses to their shareholders.[30] Instead, earnings are effectively taxed twice: once at the corporate level and again when dividends are paid to shareholders.[31] Under this tax scheme, it becomes clear why hedge funds are organized as partnerships—to allow their investors to avoid double taxation.

Given the pass-through tax structure associated with partnerships that triggers UBTI and the double taxation of corporations, it would seem that a tax-exempt organization that wants to invest in a hedge fund is presented with only two options, both requiring some tax to be paid by the organization. Either the organization can be a partner in a partnership and be taxed on UBTI,

30. *See* I.R.C. § 11.

31. *See id.* §§ 11, 301.

or the organization can be a shareholder of a corporation and receive relatively smaller tax-free returns because of an initial corporate tax on earnings as high as 35%.[32]

However, what if the tax-exempt organization could receive its tax-free dividend on an undiminished return because of a 0% corporate tax rate? Such a situation could not exist if the corporation was set up in the United States,[33] but it certainly could exist, and indeed it does, if the corporation is set up in the Cayman Islands or a similar tax jurisdiction.[34] Meet the foreign blocker corporation.[35]

B. The Foreign Blocker Corporation

In order to prevent a hedge fund from passing UBI to its tax-exempt partner, the income is instead passed from the hedge fund to a blocker corporation.[36] UBTI does not pass through from corporations to shareholders. Thus, "if tax-exempt organizations hold potentially [UBTI]-producing investments through a corporation, the . . . look through rule does not apply, and dividends paid by the corporation to the tax-exempt investors generally are excluded from the investors' unrelated business taxable income."[37] The diagram below shows a simplified blocker structure.[38]

32. *See id.* § 11.

33. *See id.*

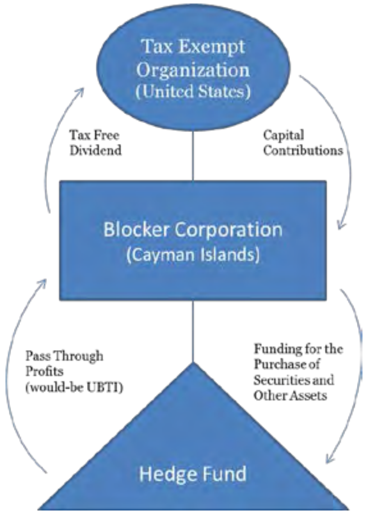
34. *See* TAX TREATMENT II, *supra* note 7, at 8.

35. "Generically, a blocker or stopper is an entity inserted in a structure to change the character of the underlying income or assets, or both, to address entity qualification issues, to change the method of reporting, or otherwise to get a result that would not be available without the use of more than one entity." Willard B. Taylor, *"Blockers," "Stoppers," and the Entity Classification Rules*, 64 TAX LAW. 1, 1 (2011). Although the blocker corporation can be used in other contexts, this Comment specifically uses the terms "blocker corporation," "blocker structure," and "blocker loophole" to reference only a tax-exempt organization's use of such a structure in a non-tax or low-tax jurisdiction.

36. *See* PRINCIPLES AND BEST PRACTICES, *supra* note 26, at 42.

37. *See* TAX TREATMENT II, *supra* note 7, at 4.

38. Most blocker corporation schemes are considerably more complex than the one depicted, but the basic graphic shown accurately represents the benefits blocker corporations provide to tax-exempt investors. Often, tax-exempts are simply a player in what is called a "master-feeder" structure, which "combines a 'master fund,' often an investment company exempt from the Investment Company Act, domiciled in a low tax or no tax jurisdiction such as the Cayman Islands, with an offshore 'feeder fund,' another exempted company domiciled in the same jurisdiction as the master fund, and an onshore LLC or LP, which is also a 'feeder fund.' Investors subscribe to the feeder funds, which 'feed' or 'upstream' their assets to the master fund, and the combined pool of assets is managed at the master-fund level. By investing in the offshore feeder, non-U.S. investors usually avoid being subject to U.S. taxes and the reporting requirements that arise when non-U.S. investors generate taxable income that is effectively



Understandably, the blocker structure has become a preferred investment model for tax-exempt organizations that wish to invest in hedge funds.[39] Not only will tax-exempt investors not have to pay tax on a dividend pay-out, but that pay-out will also not be diminished by a corporate tax rate since the corporate tax rate in the Cayman Islands is 0%.[40]

C. PFIC Rules, Tax-Exempt Organizations, and Blocker Corporations

U.S. taxpayers that are shareholders of a PFIC are taxed on the PFIC's income under a different regime that is beyond the scope of this Comment.[41] A PFIC is a foreign corporation that meets one of

connected to the conduct of a trade or business within the United States. For U.S. tax-exempt investors, the offshore feeder fund acts as a 'blocker company' and may enable these investors to avoid being subject to Unrelated Business Taxable Income ('UBTI'). This structure enables tax-exempt investors to participate in investment partnerships that use leverage as part of their investment strategy." PRINCIPLES AND BEST PRACTICES, *supra* note 26, at 41–42 (internal quotation marks and citations omitted).

39. *See*, *e.g.*, *id.* at 41–42.

40. *Cayman Islands Highlights 2012*, DELOITTE (2012), http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Taxation%20and%20Investment%20Guides/2012/dttl_tax_highlight_2012_Cayman%20Islands.pdf.

41. "Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are 'qualified electing funds,' under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. A second set of rules applies to

the following tests: (1) 75% or more of the corporation's gross income is passive income, such as dividends, interest, royalties, rents, and annuities (the "income test"); or (2) the average percentage of assets that the corporation holds that produce passive income or are held for the production of passive income during a taxable year is at least 50% (the "asset test").[42] Many blocker corporations will be classified as PFICs because they will almost certainly meet either the income or asset tests (probably both in most cases).[43]

Prior to 1998, there was some confusion regarding how the PFIC rules applied to tax-exempt organizations.[44] In 1998, the Treasury Department issued a temporary regulation that discussed how a tax-exempt organization shareholder of a PFIC is treated under § 1291.[45] The temporary regulation is now current law, and it reads, "If the shareholder of a PFIC is an organization exempt from tax under this chapter, § 1291 and these regulations apply to such shareholder only if a dividend from the PFIC would be taxable to the organization under subchapter F."[46] This particularly short regulation exempts tax-exempt organizations from the PFIC tax regime.

passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral. A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as 'marking to market.'" TAX TREATMENT II, *supra* note 7, at 19–20.

42. I.R.C. § 1297 (2012).

43. If U.S. shareholders who own at least 10% of a foreign corporation collectively own greater than 50% of a foreign corporation, the foreign corporation is classified as a "Controlled Foreign Corporation" and is subject to taxation under the rules of Subpart F rather than the PFIC regime. *See* I.R.C. § 1297(d); I.R.S. Instructions for Form 8621 (Dec. 2012), *available at* http://www.irs.gov/pub/irs-pdf/i8621.pdf. The details of Subpart F are beyond the scope of this Comment, but the Subpart F rules generally cause a U.S. shareholder to recognize deemed dividend income even though the corporation does not actually pay a dividend to the shareholder. *See* I.R.C. § 957. However, in the case of tax-exempt organizations, these deemed dividend payments are still exempt from taxation under the UBTI exceptions unless the deemed dividends payments are debt-financed. *See* TAX TREATMENT II, *supra* note 7, at 10–11; I.R.C. § 512(b).

44. *See* General Rules for Making and Maintaining Qualified Electing Fund Elections, 63 Fed. Reg. 6 (Jan. 2, 1998).

45. *See id.*

46. 26 C.F.R. § 1.1291-1 (2013). A discussion of Subpart F income is beyond the scope of this Comment.

IV. Why Congress Should Close the Blocker Loophole

Even though the IRS does not consider the blocker loophole abusive and has sanctioned its use in tax planning structures,[47] Congress should close this loophole for four main reasons: the blocker corporation is an unintended consequence of the UBTI rules, the blocker corporation structure fails a substance over form analysis, and closing the loophole will provide increased revenue to avoid the Fiscal Cliff.

A. An Unintended Consequence

The blocker corporation is a loophole that is exploited by tax-exempt organizations.[48] When Congress passed the debt-financed income rules in 1969 to prevent sophisticated sale-leaseback transactions,[49] Congress was attempting to prevent tax-exempt organizations from distorting the market. Basically, Congress did not want tax-exempt organizations to be a commercial establishment without paying the associated income taxes.

Hedge funds were not as popular of an investment vehicle in the 1960s and 1970s as they are today. Indeed, hedge funds are not specifically mentioned in the legislative history associated with the Revenue Act of 1950 or the 1969 debt-financed rules.[50] However, even though tax-exempt organizations' investments in hedge funds were not mentioned as a target of the legislation, the general idea of the legislation is still applicable. If tax-exempt organizations are going to invest in a hedge fund, they should have to pay tax on either the pass-through UBTI or on the dividend from a corporation that is an investor in the fund.

The foreign blocker loophole is simply an unintended consequence of the Revenue Acts of 1950 and 1969. The corporate blocker is not popular domestically because of relatively high domestic corporate tax rates that would be imposed on the blocker's earnings from the hedge fund. The structure is usually only financially beneficial if the blocker corporation is domiciled offshore in a low corporate tax jurisdiction. While this particular structure, and many other loopholes in the Code, are legal, that does not mean they are optimal, necessary, or even warranted.

47. *See* Brunson, *supra* note 2, at 242–45.

48. *See* SELECTED INTERNATIONAL TAX ISSUES, *supra* note 14, at 68–69.

49. *See supra* Part II.B.1.

50. *See* Brunson, *supra* note 2, at 246.

B. Failing a Substance over Form Analysis

The blocker corporation fails a substance over form analysis. U.S. taxpayers are generally bound by the economic substance of a transaction rather than by the transaction's legal form, meaning that a taxpayer will be taxed on the economic reality of a transaction even if the form or design of the transaction might indicate otherwise.[51]

The UBTI rules were enacted to prevent tax-exempt organizations from acting too much like a commercial business and to prevent them from distorting the market. With those purposes in mind, it makes sense that a tax-exempt organization has an income tax liability on income passing through from a hedge fund. A hedge fund's activities are clearly not related to any tax-exempt organization's purpose, which is why the flow through income can be taxed as UBTI.

The blocker corporation loophole allows a tax-exempt organization to receive its return on investment from the hedge fund as a tax-free dividend instead of UBI. The substance of a tax-exempt organization's investment into a hedge fund is not changed simply by inserting a blocker corporation in a zero- or low-tax foreign jurisdiction. In both cases, a tax-exempt organization is acting like a normal commercial business. The existence of a blocker corporation does not change the fact that a tax-exempt organization is still ultimately receiving a return on an investment from activities not related to the tax-exempt organization's purpose. The substance (the economic reality of receiving a return on an investment from unrelated business activity) of both transactions is largely, if not completely, the same. By utilizing the loophole, the tax-exempt organization avoids tax by merely funneling money through a foreign blocker corporation into a hedge fund rather than investing the money in the hedge fund directly. The only difference between the two investment models is the form or design of the transaction.

Although U.S. tax law respects corporations as separate legal entities[52] and the IRS has not labeled the blocker loophole as abusive,[53] a substance over form analysis is not foreign to the IRS or the courts.[54] The IRS has routinely challenged certain tax structures

51. *See* Gregory v. Helvering, 293 U.S. 465 (1935).

52. *See* SELECTED INTERNATIONAL TAX ISSUES, *supra* note 14, at 69.

53. *See* Brunson, *supra* note 2, at 242–45.

54. *See, e.g.*, *Gregory*, 293 U.S. at 467. *Gregory* is considered one of the landmark "substance over form" cases. The case involved a taxpayer that used the business reorganization rules under the Code to receive preferential tax treatment on the sale of some shares of stock. The taxpayer utilized a transaction structure or form that enabled her to claim such preferential

using a substance over form analysis, and Congress has amended previous tax laws when they were not actually working as planned.[55] Even though the IRS has sanctioned the blocker loophole, the IRS should challenge the substance of the structure. If the IRS does not do so, then Congress should change the Code in ways that will be outlined later in this Comment.

Notably, some scholars argue that the blocker corporation necessarily changes the substance of the investment because the blocker corporation, as a partner of the hedge fund, is liable for the debt that the hedge fund incurs when making its investments.[56] The tax-exempt organization would not be liable for the hedge fund's debt under the blocker structure because of the corporate veil.[57] If a tax-exempt organization cannot be held liable for the debt, then the argument is that the organization should not bear a tax burden either.

Although this argument might seem compelling, there are examples in the Code of tax-exempt private foundations being required to bear a tax burden based on the receipt of certain corporate dividends.[58] For example, § 4940 imposes an excise tax on investment income, including dividend income that a tax-exempt private foundation receives from any source.[59] It is true that the blocker corporations paying out the dividends would certainly have liability for their own debts and that liability would not be able to be passed through to the tax-exempt organization shareholder. However, the absence of liability for debt has not prevented tax-exempt private foundations from incurring a tax liability on income received from a corporate dividend payout.

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treatment, which was technically in conformity with the Code. However, the Commissioner argued that the economic substance of the transaction was actually not a business reorganization as the taxpayer claimed. Instead, the economic substance of the transaction was a dividend payment. The Court ruled in favor of the Commissioner because the newly created corporation was "nothing more than a contrivance to the end last described [to receive preferential tax treatment]. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death." *Id.* at 469–70.

55. *See supra* Part II.B.1.

56. *See* SELECTED INTERNATIONAL TAX ISSUES, *supra* note 14, at 69.

57. *See* I.R.C. §§ 11, 301 (2012).

58. *See, e.g.*, I.R.C. § 4940 (relating to investment income excise tax).

59. *Id.*

C. Increased Revenue to the Treasury

During the 2012 presidential election, voters listened to the presidential candidates talk about closing loopholes and eliminating unnecessary deductions and credits found in the Code in order to raise additional revenue.[60] The charitable tax deduction, mortgage interest deduction, and the Child Tax Credit were often discussed because many Americans are at least somewhat familiar with these issues. Although those particular deductions and credits are certainly relevant, tax reform must also include some initiatives aimed at the Code's "mysteries" that are beyond the familiarity of the average American voter and not easily printed on a bumper sticker.

If Congress were to close the blocker loophole, which only benefits the wealthiest and most sophisticated tax-exempt organizations,[61] it would not likely cause too much public criticism because many Americans probably do not realize that asset-rich tax-exempt organizations utilize complex international tax structures to avoid an increased tax liability. Hence, Americans might be receptive to multi-billion dollar university endowments paying an increased tax bill. Moreover, closing loopholes like the foreign blocker loophole might be one way for the United States to attempt to rectify its massive debt crisis. Although the United States has far from a balanced budget, revenue increases seem to be a necessary component of a balanced approach to solving the United States' financial woes.[62]

V. CLOSING THE LOOPHOLE

This Comment will now discuss several ways Congress could close the blocker loophole. Some suggestions would completely close the loophole for all tax-exempt organizations, and others would only

60. *See Transcript of First Presidential Debate*, N.Y. TIMES (Oct. 3, 2012), http://www.nytimes.com/2012/10/03/us/politics/transcript-of-the-first-presidential-debate-in-denver.html?pagewanted=all.

61. More often than not, only the wealthy and highly sophisticated taxpayer can afford to take advantage of loopholes because professional tax lawyers and accountants are needed to perform highly technical readings of the Code and provide written opinions for complex tax structures. In additional to a professional opinion from a tax firm, tax payers will often also pay the firm to draft private letter rulings from the IRS to ensure the organization will not be audited. Typical private letter rulings cost a client around $50,000. *See PRIs and Private Letter Rulings*, AMERICANS FOR COMMUNITY DEV., http://americansforcommunitydevelopment.org/downloads/PRIsAndPrivateLetterRulings.pdf (last visited Dec. 17, 2012).

62. *See Transcript of First Presidential Debate*, *supra* note 60. In a recent press conference, President Barack Obama seemed open to the idea of closing loopholes as a means of raising revenue. *Id.*

partially close the loophole with respect to private foundations. This Comment argues that the optimal approach is to completely close the loophole, given the reasons discussed above. However, partially closing the loophole might be the most practical solution considering the political realities Congress must deal with while enacting tax reform.

A. Completely Closing the Blocker Loophole

Although partially closing the blocker loophole is a possibility, Congress should completely close the loophole by targeting the core parts of the Code that facilitate the loophole: the PFIC rules and the UBTI rules. Congress could completely close the blocker loophole by amending both the PFIC rules and the UBTI exceptions.

1. Amend the PFIC rules

The first step to closing the blocker loophole is for Congress to amend the PFIC rules. Although the taxing scheme that applies to PFICs[63] is beyond the scope of this Comment, it is important to note that many foreign blocker corporations will qualify as PFICs under § 1291 by either meeting the income test or asset test, and thus be subject to the PFIC tax and interest regime.[64] The Regulations, however, state that "[i]f the shareholder of a PFIC is an organization exempt from tax under this chapter, § 1291 and these regulations apply to such shareholder only if a dividend from the PFIC would be taxable to the organization under subchapter F."[65] Therefore, the PFIC regime generally does not apply to tax-exempt organizations receiving dividends from a blocker corporation.

Congress should strike Treasury Regulation 1.1291-1(e). If this specific regulation was amended, tax-exempt organizations, as shareholders in foreign blocker corporations, would incur a PFIC tax liability. Perhaps the most significant benefit to amending the PFIC rules is simplicity. Congress would not need to write new statutory language, except perhaps a few words to clarify that a tax-exempt organization can indeed be subject to the PFIC regime.

A tax-exempt organization utilizing the blocker corporation would be presented with a choice under the amended PFIC rules: the

63. TAX TREATMENT II, *supra* note 7, at 19–20.

64. *See supra* notes 40–42 and accompanying text.

65. 26 C.F.R. § 1.1291-1(e)(1) (2013). Although a discussion of Subpart F income is beyond the scope of this Comment, one example of taxable Subpart F income to a tax-exempt organization is debt-financed income.

organization can be subject to the PFIC tax regime or invest directly into the hedge fund and pay a tax on the pass-through UBTI from the hedge fund. Both choices result in a tax that should eliminate the tax benefits of the blocker loophole.

2. Amend the UBTI exceptions

The second step to completely closing the blocker loophole is for Congress to amend the UBTI rules, which impose a tax on any part of a tax-exempt organization's income that meets the following requirements: (1) income received was 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 was not "substantially related" to the tax-exempt organization's purpose.[66] The Code carves out certain exceptions to the UBTI rules, including dividends, which consequently, but inadvertently, include dividends from blocker corporations.[67] Section 512(b)(1) should be amended to disallow an exception for dividends paid by foreign corporations that are partners in a hedge fund. Section 512(b)(1) currently reads:

> There shall be excluded all dividends, interest, payments with respect to securities loans (as defined in subsection (a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income.[68]

Congress should add a new sentence to the end of the current provision which states:

> *This section shall not apply to dividends, interest, payments with respect to securities loans (as defined in subsection (a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, annuities, and all deductions directly connected with such income if they are received from a foreign corporation that is a partner in a hedge fund.*

The proposed amendment would force tax-exempt organizations that use the blocker structure to pay a tax on a dividend received from the blocker corporation. As with the proposed PFIC changes, the proposed change to § 512(b)(2) offers a tax-exempt organization a choice: pay a tax on dividends received from foreign blocker corporations or invest directly into the hedge fund and pay an

66. *See* I.R.C. §§ 511–13 (2006 & Supp. V 2012).

67. *Id.* § 512(b).

68. *Id.* § 512(b)(1).

income tax as a partner of the hedge fund. Both choices result in a tax on pass-through UBTI. These choices should deter the use of the blocker corporation and keep more capital in the United States, which makes sense because many hedge funds' actual assets are located in the United States.[69]

B. Partially Closing the Blocker Loophole

As lawmakers consider closing the blocker loophole, they will undoubtedly be met with special interest opposition from tax-exempt organizations and their lobbyists. Since Congress might not be willing to make political enemies with all tax-exempt organizations at once, this Comment proposes several solutions to partially close the blocker loophole. Admittedly, these suggestions would probably not solve the problem, but at least these suggestions would start the process. Under the following proposals, Congress would increase the § 4940 and § 4944 taxes on private foundations. Then, over time, Congress could extend these reforms to all tax-exempt organizations by amending § 509.

1. Increase the 4940 excise tax

One way to close the blocker loophole with respect to tax-exempt private foundations is to make the § 4940 excise tax steeper. Section 4940 states in part:

> There is hereby imposed on each private foundation which is exempt from taxation under section 501(a) [26 U.S.C. § 501(a)] for the taxable year, with respect to the carrying on of its activities, a tax equal to 2 percent of the net investment income of such foundation for the taxable year.[70]

If private foundations are investing large amounts of money and receiving decent returns, a 2% tax amounts to nothing more than a small price to pay for doing business unrelated to their tax-exempt purposes. Although the legislative history to § 4940 "indicates that the purpose of the tax is to raise only enough revenue to finance the administration of the code provisions relating to private foundations and other tax-exempt organizations,"[71] Congress could choose to substantially increase the excise tax with respect to dividends paid

69. *See* SELECTED INTERNATIONAL TAX ISSUES, *supra* note 14, at 69.

70. I.R.C. § 4940(a) (2012).

71. Richard R. Upton, *Private Foundations: Many Routine Investment Activities Are Neither Subject to the Section 4940 Excise Tax nor to UBIT*, 38 EXEMPT ORG. TAX REV. 393, 394 (2002).

from blocker corporations. For example, the excise tax on investment income received from blocker corporations could be equal to the tax-exempt organization's income tax rate, which would effectively put an income tax on the blocker payouts. Thus, § 4940 could be modified as follows:

> There is hereby imposed on each private foundation which is exempt from taxation under section 501(a) [26 U.S.C. § 501(a)] for the taxable year, with respect to the carrying on of its activities, a tax equal to 2 percent of the net investment income of such foundation for the taxable year, *unless the investment income is derived from a foreign corporation that is a partner in a hedge fund, which would then trigger a tax on the foundation's net investment income from the foreign corporation.*

Such a change would effectively remove the tax benefit of the blocker loophole because the dividends the foundation receives from foreign blockers will not be exempt under the UBTI rules.

2. Change § 4944 and its corresponding Regulations

Section 4944 of the Code imposes a 10% tax on investments that may jeopardize a private foundation's tax-exempt purpose.[72] The Regulations state that

> an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.[73]

Importantly, no category of investments is treated as a per se violation of § 4944.[74] The Regulations give several examples of jeopardizing transactions. Although the blocker structure is not described in one of the examples, perhaps the following example is somewhat related:

> A is a foundation manager of B, a private foundation with assets of $100,000. A approves the following three investments by B after taking into account with respect to each of them B's portfolio as a

72. I.R.C. § 4944(a)(1) (2012).

73. 26 C.F.R. § 53.4944-1(a)(2) (2013).

74. *Id.*

> whole: (1) An investment of $5,000 in the common stock of corporation X; (2) an investment of $10,000 in the common stock of corporation Y; and (3) an investment of $8,000 in the common stock of corporation Z. Corporation X has been in business a considerable time, its record of earnings is good and there is no reason to anticipate a diminution of its earnings. Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. Z's stock is classified as a high-risk investment by most investment advisory services with the possibility of substantial long-term appreciation but with little prospect of a current return. A has studied the records of the three corporations and knows the foregoing facts. In each case the price per share of common stock purchased by B is favorable to B. Under the standards of paragraph (a)(2)(i) of this section, the investment of $10,000 in the common stock of Y and the investment of $8,000 in the common stock of Z may be classified as jeopardizing investments, while the investment of $5,000 in the common stock of X will not be so classified. B would then be liable for an initial tax of $500 (i.e., 5 percent of $10,000) for each year (or part thereof) in the taxable period for the investment in Y, and an initial tax of $400 (i.e., 5 percent of $8,000) for each year (or part thereof) in the taxable period for the investment in Z. Further, since A had actual knowledge that the investments in the common stock of Y and Z were jeopardizing investments, A would then be liable for the same amount of initial taxes as B.[75]

Judging from the language of the Regulation and its corresponding example that labeled investments in companies Y and Z as jeopardizing, investments hit with the § 4944 excise tax are analyzed on a case-by-case basis. Since no category of investment can be a per se violation of this Regulation, the blocker structure, especially if it is overseen by sophisticated tax lawyers and accountants, is not likely to be subject to this Regulation as written unless unusual circumstances are present.

The Treasury Department should expand the example to include a tax-exempt organization investing in a corporate blocker that is a

75. 26 C.F.R. § 53.4944-1(c) (2013).

shareholder in a heavily leveraged hedge fund. The expanded example should therefore read:

> A is a foundation manager of B, *a private foundation with assets of $120,000*. A approves *the following four investments* by B after taking into account with respect to each of them B's portfolio as a whole: (1) An investment of $5,000 in the common stock of corporation X; (2) an investment of $10,000 in the common stock of corporation Y; (3) an investment of $8,000 in the common stock of corporation Z; *and (4) an investment of $10,000 in the common stock of F, a foreign corporation that is a partner in a hedge fund*. Corporation X has been in business a considerable time, its record of earnings is good and there is no reason to anticipate a diminution of its earnings. Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. Z's stock is classified as a high-risk investment by most investment advisory services with the possibility of substantial long-term appreciation but with little prospect of a current return. *Corporation F is a foreign corporation that primarily invests in hedge funds that engage in leveraged investments. In this case, the hedge fund is heavily leveraged.* A has studied the records of the three corporations and knows the foregoing facts. In each case the price per share of common stock purchased by B is favorable to B. Under the standards of paragraph (a)(2)(i) of this section, the investment of $10,000 in the common stock of Y, the investment of $8,000 in the common stock of Z, *and the $10,000 investment in the common stock of F* may be classified as jeopardizing investments, while the investment of $5,000 in the common stock of X will not be so classified. B would then be liable for an initial tax of $ 500 (i.e., 5 percent of $10,000) for each year (or part thereof) in the taxable period for the investment in Y, an initial tax of $ 400 (i.e., 5 percent of $8,000) for each year (or part thereof) in the taxable period for the investment in Z, *and an initial tax of $500 (i.e., 5 percent of $10,000 for each year (or part thereof) in the taxable period for the investment in F*. Further, since A had actual knowledge that the investments in the common stock of Y, Z, *and F* were jeopardizing investments, A would then be liable for the same amount of initial taxes as B.

If such an example were included, it would give courts an opportunity to rule that excessive leveraging could be a factor in determining a jeopardizing investment. The excise tax could remain at 10% because the excise tax is imposed on the value of the investment rather than the return on the investment.

3. Extend the proposed changes to § 4940 and § 4944 to all tax-exempt organizations

Once the proposed changes to § 4940 and § 4944 are implemented, Congress should then extend the changes to all tax-exempt organizations. The most efficient way for Congress to accomplish the extension of § 4940 and § 4944 to all tax-exempt organizations is to amend § 509, which is the section that defines "private foundation."[76] Congress should add a subpart to § 509 that reads, "Any organization that normally would not be defined as a private foundation will be considered a private foundation with respect to dividends received from a foreign corporation that is a partner in a hedge fund and with respect to investments made into a foreign corporation that is a partner in a hedge fund."

VI. Conclusion

Tax-exempt organizations should not be able to receive tax-free dividends from foreign blocker corporations that invest in hedge funds for three reasons: the blocker corporation is an unintended consequence of the UBTI rules, the blocker corporation structure fails a substance over form analysis, and closing the loophole will provide increased revenue to the United States Treasury. With those reasons in mind, Congress should close the blocker loophole using one of two strategies. Perhaps the most practical strategy is for Congress to increase the excise taxes on private foundations and then apply those excise taxes to all other tax-exempt organizations over time. Ideally, Congress should completely close the blocker loophole for all tax-exempt organizations by amending PFIC and UBTI rules. In the meantime, tax-exempt organizations will continue to utilize the blocker loophole and invest in unrelated business activities abroad with minimal income tax consequences.

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76. I.R.C. § 509 (2012).

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