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Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities

Emily Cauble*

Educational endowments, private employer-sponsored pension plans, and other tax-exempt organizations (collectively, “tax-exempt entities”) invest a substantial amount of capital in various sectors of the economy, and tax consequences can determine whether or not a tax-exempt entity, like any other entity, makes a potential investment. Consequently, the tax treatment of investment income earned by tax-exempt entities can affect significantly the manner in which capital is allocated on an economy-wide basis.

The current tax system applies different effective rates of tax to income earned by tax-exempt entities from otherwise comparable investments. This inconsistent tax treatment distorts investment decisions made by such entities which, given the amount of capital invested by such entities, can result in a less than optimal allocation of capital. In some contexts, the distortion can be mitigated by tax structuring. However, if Congress were to enact legislation currently proposed as part of the Stop Tax Haven Abuse Act, the ability to engage in this tax structuring would be eliminated. Thus, enactment of the proposed legislation would exacerbate the current distortions without providing any offsetting benefits.

In lieu of reforms suggested by Congress, this paper proposes reforms to the manner in which tax-exempt entities are taxed on their investment income. In particular, this paper proposes that a tax-exempt investor would generally not be subject to tax on income earned from an entity whose business decisions are not controlled by the tax-exempt investor. The proposed reforms would result in a better allocation of capital among various investment opportunities. The reforms would not subvert any of the other goals of taxing income earned by tax-exempt entities. Finally, the reforms would modernize the tax rules in a way that takes into account changes to investment portfolios held by tax-exempt entities that have occurred since the rules were enacted.

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Introduction

The Harvard Management Company invested Harvard University’s endowment in a portfolio that generated an overall return of 8.6% for the fiscal year ending in 2008. Over the same time period, the S&P 500 index fell by 13.1%. In its annual report for the 2008 fiscal year, the Harvard Management Company boasted that it achieved this impressive return “under very challenging market conditions,” and the Harvard Management Company attributed its success, in large part, to its meticulous efforts to maintain a widely diversified portfolio of assets. This portfolio included not only equity in publicly-traded corporations whose lackluster performance contributed to the falling S&P 500 index but also alternative investments such as hedge funds, real estate funds, and private equity funds. By the close of the following year, however, Harvard’s endowment was no longer immune to “challenging market conditions,” as the endowment accrued a negative 27.3% return for the fiscal year ending in 2009.

While a widely diversified pool of assets could not insulate Harvard’s endowment from an economic crisis that impacted virtually all sectors of the economy, Harvard will continue to pursue a strategy of diversification in order to preserve its wealth during economic downturns that are less widespread. Moreover, its diversification strategy will continue to include investment in hedge funds, real estate funds, and private equity funds.

In fact, the amount invested in such funds is, and likely will continue to be, quite significant. Educational endowments (like Harvard’s), private employer-sponsored pension plans, and other tax-exempt organizations (collectively, “tax-exempt entities”) invest billions of dollars in hedge funds, real estate funds, and private equity funds. As a result of the magnitude of their investment, investment decisions made by tax-exempt entities can appreciably impact the manner in which capital is allocated among these funds. Furthermore, the current tax

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1 HARVARD UNIVERSITY FINANCIAL REPORT (2008), http://vpf-web.harvard.edu/annualfinancial/
2 Id.
3 Id.
4 Id. For further discussion of the inclusion of alternative asset classes in a diversified portfolio, see infra note 32.
5 HARVARD UNIVERSITY FINANCIAL REPORT (2009), http://vpf-web.harvard.edu/annualfinancial/
6 Id. (“With perfect hindsight we and most other investors would have started this year in a more liquid position and with less exposure to some of the alternative asset categories that were hardest hit during fiscal 2009. It is important to note, however, that our portfolio has benefited greatly from our asset allocation over the long-term, which has included substantial exposure to less conventional asset classes.”)
7 See infra notes 30 and 31.
treatment of an investment in such a fund by a tax-exempt entity can likely distort investment decisions in a way that leads to a less than optimal allocation of capital among various funds. To make matters worse, the enactment of currently proposed legislation regarding the use of “blocker corporations”⁸ could exacerbate this capital allocation problem, at least in the hedge fund context.

The tax system generally does not aim to tax investment income earned by tax-exempt entities.⁹ As a result of how the current rules define what constitutes investment income, a tax-exempt investor is generally not subject to tax on income earned from an entity treated as a corporation for tax purposes. However, perhaps because the current rules were adopted at a time when investment holdings by tax-exempt entities generally did not consist of interests in partnerships, a tax-exempt investor is subject to tax on certain types of income earned from an entity treated as a partnership for tax purposes. Unlike when the current rules were adopted, however, today tax-exempt entities do invest substantial sums in entities treated as partnerships because hedge funds, real estate funds, and private equity funds are treated as partnerships.¹⁰

Moreover, as a consequence of current tax rules, when a tax-exempt entity selects among competing investment choices treated as partnerships for tax purposes, tax considerations can bias the tax-exempt entity towards investing in the partnership that generates income subject to a lower effective tax rate in the tax-exempt entity’s hands. In the hedge fund context, tax-exempt entities are currently able to engage in tax structuring that eliminates tax liability incurred as a result of an investment in such funds. Consequently, tax-exempt entities currently select among hedge funds based on non-tax factors. However, comparable tax structuring techniques are not as effective in the context of real estate funds and private equity funds due to the nature of the underlying investments of such funds. Therefore, investment decisions in the context of real estate funds and private equity funds remain vulnerable to distortion under the current tax system.

This paper proposes modest reform to the current tax treatment of income earned by tax-exempt entities. In particular, this paper proposes that the current rules, which generally aim to not tax investment income earned by tax-exempt entities, should be updated in order to reflect the fact that, today, tax-exempt entities derive

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⁸ See infra notes 92 to 94 and accompanying text.
⁹ This is the case as long as the income is not debt-financed. See infra notes 18 to 21 and accompanying text.
¹⁰ Or, at least they would be, but for tax structuring undertaken to accommodate tax-exempt investors. See infra notes 33 to 56 and accompanying text.
substantial investment income from partnerships. Specifically, under the reforms proposed by this paper, if a tax-exempt investor holds an interest in a partnership as a truly passive investor, meaning the tax-exempt investor does not control business decisions made by the partnership, the tax-exempt investor would not be subject to tax on income earned from the partnership.

As a consequence of the reforms proposed by this paper, when a tax-exempt investor selects among competing investment choices treated as partnerships, the tax-exempt investor would make the decision based on non-tax factors, since income from each partnership would be taxed equally. In addition to leading to a better allocation of capital among various investment opportunities, the reforms proposed by this paper should not subvert any of the other goals of taxing income earned by tax-exempt entities.

In contrast to the reforms proposed by this paper, legislation regarding the use of “blocker corporations” proposed by Congress as part of the “Stop Tax Haven Abuse Act” would lead to increased distortions in investment decisions made by tax-exempt entities, without providing any offsetting benefits. If Congress were to enact the proposed legislation, the tax structuring currently employed by tax-exempt entities in the hedge fund context would no longer be feasible. Thus, Congressional proposals would generally increase the tax rate that applies to an investment in certain hedge funds by a tax-exempt entity and, more importantly, introduce additional variation to the manner in which income is taxed across funds. As a result, tax consequences would enter the equation when a tax-exempt entity evaluates different hedge funds, and consideration of tax consequences could distort investment decisions, making them inconsistent with decisions that would have been made based on non-tax factors. On the other hand, the reforms proposed by this paper would generally eliminate any tax that applies to income earned by a tax-exempt entity from an investment in a hedge fund, real estate fund, or private equity fund and, more importantly, equalize the manner in which income is taxed across funds. Therefore, the reforms proposed by this paper should result in a more optimal allocation of capital among various investment opportunities, compared to allocations that would be made if reforms proposed by Congress were enacted.

This paper proceeds in six parts. Part I describes the manner in which investments by tax-exempt entities are currently taxed. Part II describes various goals of the current taxation of income earned by tax-exempt entities. Part III discusses reforms that have been proposed by Congress as part of the “Stop Tax Haven Abuse Act”. Part IV proposes reforms to the tax treatment of investments by tax-exempt entities that should be adopted in lieu of reforms proposed by Congress. Part V evaluates the proposed reforms by analyzing the likely impact of the
reforms on each of the goals of taxing income earned by tax-exempt entities. Part VI concludes.

1. **Current System**

Tax-exempt entities are generally not subject to U.S. federal income tax. However, since the adoption of the “unrelated business income tax” (or the “UBIT”) in 1950, tax-exempt entities have been subject to U.S. tax on income earned from certain activities and investments.\(^\text{11}\)

a. **Contours of the UBIT**

As currently in effect, the UBIT requires that a tax-exempt entity pay tax at regular corporate tax rates on income derived from a trade or business regularly carried on by the tax-exempt entity and not substantially related to its exempt purpose.\(^\text{12}\) Whether or not something constitutes a “trade or business” is a fact-specific inquiry, guided by the same considerations that apply for purposes of determining whether or not expenses will be allowed as business deductions.\(^\text{13}\) Courts have held that whether or not a taxpayer is engaged in an activity for the purpose of earning a profit is the most important factor in determining whether or not a taxpayer is engaged in a “trade or business”.\(^\text{14}\)

Generally, trade or business activities are “regularly carried on” if they are carried on frequently and continuously and in a manner similar to comparable commercial activities in which taxable entities engage.\(^\text{15}\) The Treasury Regulations provide that business activities are “related” to an entity’s exempt purposes “only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income)”. Furthermore, business activities are “substantially related” to an entity’s exempt purposes only if this causal relationship is “a substantial one”.\(^\text{16}\)

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\(^\text{12}\) See I.R.C. §§ 511 – 513. In the case of tax-exempt entities that are trusts, the UBIT is applied at rates generally applicable to taxable trusts. I.R.C. § 511(b).
\(^\text{13}\) See Treas. Reg. § 1.513-1(b).
\(^\text{15}\) See Treas. Reg. § 1.513-1(c)(1). For a more comprehensive explanation of the “regularly carried on” requirement, see HOPKINS, supra note 14, at 659 - 63.
\(^\text{16}\) See Treas. Reg. § 1.513-1(d). For a more complete account of the “substantially related” requirement, see HOPKINS, supra note 14, at 663 - 73.
Thus, for example, tuition payments received by Harvard from the provision of educational services would not be subject to the UBIT since the provision of educational services furthers (and indeed is) the institution’s purpose that justifies exemption from tax.\textsuperscript{17}

b. UBIT As Applied to Investment Income

i. In General

The Internal Revenue Code specifically lists certain types of income that generally will not be subject to the UBIT even if they might otherwise constitute income from a trade or business, regularly carried on by the tax-exempt entity and not substantially related to its tax-exempt purpose.\textsuperscript{18} The types of income listed are various types of investment income, including: (1) dividends, (2) interest, (3) royalties, (4) rents arising primarily from real property, and (5) gain from the sale of property that is not inventory or property held primarily for sale to customers in the ordinary course of a trade or business (i.e. capital gain income).\textsuperscript{19}

ii. The Debt-Financed Income Rules

Despite the general rule that dividends, interest, rent, and the like will not be subject to the UBIT, if a tax-exempt entity borrows money to finance the acquisition of an asset that is not related to its exempt purpose, a portion of the investment income earned from the asset that, ordinarily, would not be subject to the UBIT becomes subject to the UBIT.\textsuperscript{20} An exception to this “debt-financed income” rule is granted for debt-financed income from real estate in certain cases. In particular, provided that various requirements are met, pension plans, educational institutions, educational endowments, and certain other tax-exempt entities are not subject to the UBIT on otherwise exempt debt-financed income from real estate.\textsuperscript{21}

c. UBIT As Applied to a Tax-Exempt Partner in a Partnership

i. In General

Under current law, the activities of a partnership are attributed to its partners for purposes of determining whether or not a tax-exempt

\textsuperscript{17} The “substantially related” test, in fact, likely would allow for exemption of income that is even further afield than tuition payments from the entity’s core purpose. See infra note 77 and accompanying text.
\textsuperscript{18} I.R.C. § 512(b).
\textsuperscript{19} Id.
\textsuperscript{20} I.R.C. § 514.
\textsuperscript{21} I.R.C. § 514(c)(9).
entity realizes income subject to the UBIT as a result of an investment in a partnership. Therefore, if a partnership engages in an activity that would be an unrelated trade or business if a tax-exempt partner engaged in the activity directly, income allocated to the tax-exempt partner by the partnership with respect to such activity will be subject to the UBIT. In addition, if a partnership borrows money to finance the acquisition of an asset that is not related to a tax-exempt partner’s exempt purpose, the debt-financed income rules discussed above make a portion of what would otherwise be exempt income (such as dividend income, interest income, rental income, or the like) allocated to the tax-exempt partner with respect to the asset subject to the UBIT, except for debt-financed income from real estate in some cases. All of the foregoing rules apply whether the tax-exempt partner is actively involved in making decisions regarding the partnership’s business or is a passive investor in the partnership who is not involved in making decisions regarding the partnership’s business. Accordingly, current law exposes a tax-exempt partner (even one investing passively) to the UBIT in two main situations: first, when the partnership operates a business that would be considered “unrelated” to the tax-exempt partner’s exempt purpose and second, when the partnership earns income that would be subject to the UBIT as a result of the debt-financed income rules discussed above.

ii. Compared to Investment in a Corporation

To put the above description in more concrete terms, if a tax-exempt entity owns shares of stock in Kraft Foods, Inc., dividends received by the tax-exempt entity and capital gain income earned from sale of shares by the tax-exempt entity will not be subject to the UBIT, regardless of the business activities of Kraft Foods, Inc. If, on the other hand, a tax-exempt entity owns an interest in a partnership that engages in the manufacture and sale of food products unrelated to the tax-exempt entity’s exempt purpose, income allocated to the tax-exempt entity by the partnership will be subject to the UBIT, even if the tax-exempt entity has no control over the business decisions of the partnership.

22 I.R.C. § 512(c)(1). A similar rule provides that any non-U.S. partner in a partnership will be treated as engaged in a U.S. trade or business if the partnership is engaged in a U.S. trade or business. I.R.C. § 875(1).
25 See, e.g., Priv. Ltr. Rul. 2002-51-016 (Dec. 30, 2002), Priv. Ltr. Rul. 2002-51-018 (Dec. 30, 2002). However, if the tax-exempt entity finances its acquisition of the stock with debt, then a portion of the dividends would be subject to the UBIT, under the debt-financed income rules.
26 See supra notes 22 and 24.
Likewise, if a tax-exempt entity owns shares of stock in a corporation that, in turn, borrows money to finance the acquisition of assets, dividends received by the tax-exempt entity and capital gain income earned from sale of shares by the tax-exempt entity will not be subject to the UBIT.27 If, on the other hand, a tax-exempt entity owns an interest in a partnership that borrows money to finance the acquisition of assets that are not related to the tax-exempt entity’s exempt purpose, a portion of income that would not otherwise be subject to the UBIT (such as dividend income, interest income, rental income,28 or the like) allocated to the tax-exempt entity by the partnership will become subject to the UBIT per the debt-financed income rules discussed above.29

d. **UBIT In the Context of Common Investment Activity by Tax-Exempt Entities**

In addition to investing a substantial amount of capital in publicly-traded corporations,30 educational endowments, private employer-sponsored pension plans, and other tax-exempt entities invest substantial sums of money in hedge funds, real estate funds, and private equity funds each year.31 Tax-exempt entities invest in these funds in order to diversify their investment portfolios and earn high returns on their investment.32 But for tax planning undertaken to

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27 This is true provided that the tax-exempt entity does not finance its acquisition of the shares with debt.
28 This statement is subject to the special exception for debt-financed income from real estate that applies to certain tax-exempt entities as long as certain requirements are met. *See supra* note 21 and accompanying text.
29 *See supra* note 23.
30 For example, the September 17, 2009 Federal Reserve Flow of Funds table L. 213 reports that, as of the second quarter of 2009, $1.7 trillion worth of corporate equities were held by private pension funds.
31 For example, while educational endowments, on average invested 40% of their portfolio in corporate equities in 2008, the comparable percentage for real estate was 6.5%, the comparable percentage for hedge funds was 21%, and the comparable percentage for private equity funds was 8.4%. 2008 NACUBO Endowment Study Results – Table: Average Asset Class Allocation of Total Assets, available at www.Nacubo.org. Furthermore, according to the Milliman 2009 Pension Funding Study, the percentage of pension fund assets invested in “other” asset classes (which includes real estate, private equity, hedge funds, and cash equivalents) was 15% compared to 44% for corporate equities. http://www.milliman.com/expertise/employee-benefits/products-tools/pension-funding-study/pdfs/2009-pension-funding-study-03-01-09.pdf.
32 See, e.g., DAVID F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT: AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT, 63, 115, 181, 199, 220 (2009) (describing investment in private equity as a means to bear higher risk and earn a greater return compared to investment in equity of publicly-traded companies and describing investment in real estate as an effective means to more fully diversify an institution’s investment portfolio).
minimize the amount of UBIT incurred as a result of an investment in such funds, such funds would be treated as partnerships for tax purposes. This section will begin by discussing how tax-exempt entities would be taxed with respect to typical activities undertaken by such funds, absent tax structuring. Next it will discuss the impact of tax structuring on the tax consequences of investing in such funds.

i. **Tax Treatment Absent Tax Planning**

1. **Hedge Funds**

Hedge funds primarily own assets that generate passive types of income (such as capital gain income, interest income, and the like) that are generally exempt from the UBIT, provided that such types of income are not derived from assets financed with debt. However, hedge funds frequently acquire assets using the proceeds of borrowing. Therefore, if a tax-exempt entity invests in a hedge fund treated as a partnership for U.S. tax purposes, generally the tax-exempt entity will be subject to the UBIT on a portion of the income it earns from the hedge fund under the debt-financed income rules, and the size of the portion of income subject to the UBIT will depend on the extent to which the hedge fund employs leverage.  

2. **Real Estate Funds**

Unlike hedge funds, where the primary UBIT risk results from the debt-financed income rules, real estate funds present UBIT risks from unrelated active business income as well as debt-financed income. Unrelated business income risk arises in the case of a real estate fund that sells “dealer” property, such as condominiums and other housing units, because the gain from sale of such property is subject to the UBIT assuming the sale of the property is unrelated to the tax-exempt investor’s exempt purpose.

Real estate funds also use leverage to acquire investment properties that produce otherwise passive rental income or capital gain upon eventual sale that, but for the debt-financed income rules, would not be subject to the UBIT. The application of the debt-financed income

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33 *See supra* note 23. It should be noted, however, that not all means by which hedge funds leverage their returns in an economic sense will constitute use of leverage for purposes of the debt-financed income rules. For example, the Internal Revenue Service has ruled that income subject to the UBIT under the debt-financed income rules does not result when a tax-exempt entity sells publicly-traded stock short through a broker. Rev. Rul. 95-8, 1995-4 I.R.B. 29. The Internal Revenue Service reached this conclusion despite the fact that selling publicly-traded stock short through a broker implicitly involves the use of leverage since the tax-exempt entity, through its broker, borrows the shares of stock being sold short and is obligated to return the shares to the broker.
rules, however, results in some portion of rental income and gain upon eventual sale being subject to the UBIT, unless the tax-exempt entity is a pension plan, educational institution, educational endowment, or other tax-exempt organization that is entitled to the benefits of the special UBIT exemption for debt-financed income from real estate and the partnership complies with certain other, burdensome requirements. \footnote{See I.R.C. § 514. In addition to meeting other requirements, the partnership agreement must comply with the “fractions rule” and contain allocations that have “substantial economic effect”. Doubt exists regarding whether or not partnership agreements can comply with these requirements when they contain certain commonplace business terms (such as clawback provisions requiring a sponsor to return amounts to the partnership for distribution to the investors on liquidation of the partnership, if the sponsor has received a greater amount of carried interest than the amount to which the sponsor is entitled over the life of the fund). For a more complete description of business terms that might be incompatible with complying with these requirements, see Richard M. Nugent, Possible Approaches for Avoiding UBIT on Real Estate Investments, 815 PLI/Tax 387, 399 – 408 (2008).}

3. **Private Equity Funds**

Private equity funds, like real estate funds, present UBIT risks to tax-exempt investors as a result of both unrelated business income and the application of the debt-financed income rules. Regarding unrelated business income, the private equity fund may itself own partnership interests or other non-corporate equity interests in entities that earn active business income while held by the private equity fund. As a result, a tax-exempt investor in the private equity fund would be subject to the UBIT on its share of the underlying active business income. \footnote{See supra notes 22 and 24.}

Regarding debt-financed income, private equity funds often leverage their investments, and, as a result of the debt-financed income rules, tax-exempt investors can be subject to the UBIT on debt-financed dividend income, interest income, and similar income that, but for the debt-financing, would not be subject to the UBIT. \footnote{See I.R.C. § 514 (setting forth the debt-financed income rules).}

ii. **Available Structuring Options to Avoid Potential UBIT**

1. **Hedge Funds**

In order to minimize tax liability incurred by U.S. tax-exempt investors under current law, hedge fund sponsors commonly form a separate entity (the “TE Investor Parallel Fund”) through which such investors will own an interest in the assets acquired by the hedge fund. The TE Investor Parallel Fund will typically be organized in a non-U.S. tax
haven jurisdiction, and the TE Investor Parallel Fund will elect to be treated as a corporation for U.S. tax purposes. Because the types of income earned by hedge funds (predominantly capital gain income and interest income) are generally not the types of income that are subject to U.S. federal income tax when earned by a non-U.S. corporation, the TE Investor Parallel Fund will generally not be subject to corporate-level U.S. federal income tax. Furthermore, because the TE Investor Parallel Fund is organized in a tax haven, the TE Investor Parallel Fund will generally not be subject to income tax in the jurisdiction in which it is organized. Finally, because the TE Investor Parallel Fund is treated as a corporation for U.S. tax purposes, income earned by tax-exempt investors from the TE Investor Parallel Fund will be dividend income and capital gain income, generally exempt from the UBIT regardless of the activities of the TE Investor Parallel Fund and regardless of the amount of debt incurred by the TE Investor Parallel Fund to finance its assets. Therefore, the TE Investor Parallel Fund, commonly called a “blocker corporation” for its UBIT-blocking capabilities, effectively converts what would otherwise be debt-financed income subject to the UBIT under the debt-financed income rules into UBIT-exempt dividend and capital gain income, a result that has been sanctioned by the Internal Revenue Service in private letter rulings.

2. **Real Estate Funds**

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38 Because the TE Investor Parallel Fund is organized outside the U.S. and elects to be treated as a corporation for U.S. tax purposes, the TE Investor Parallel Fund is a non-U.S. person for U.S. tax purposes. See I.R.C. § 7701(a)(30)(C). As a non-U.S. person, the TE Investor Parallel Fund is only subject to U.S. tax on income that is effectively connected with a U.S. trade or business or income that is U.S. source income. See I.R.C. §§882 and 881. Capital gain income, interest income, dividend income, and the like would generally not constitute income that is effectively connected with a U.S. trade or business. See I.R.C. § 864(b)(2)(A)(ii). Capital gain income earned by a non-U.S. person would not generally constitute U.S. source income. See I.R.C. § 865(a)(2). Furthermore, while dividend income or interest income paid by a U.S. company in which the hedge fund invests likely would constitute U.S. source income potentially subject to withholding, interest income earned by hedge funds will often be entitled to an exemption for withholding provided for portfolio interest. See I.R.C. §§ 881(a), 863(a)(1), 863(a)(2) and 881(c).

39 This is the case provided that the tax-exempt investors do not use debt to finance their acquisition of an interest in the TE Investor Parallel Fund.

As discussed above, if a tax-exempt entity invests in a real estate fund that is treated as a partnership for tax purposes, the tax-exempt entity could likely be subject to the UBIT as a result of two potential income sources (in particular, gain arising from the sale of dealer property and debt-financed income from non-dealer property). Very effective structuring options exist that can minimize UBIT liability incurred as a result of the second source of income but not the first. Regarding the first source of income, the ability of real estate funds to use the blocker corporation strategy used by hedge funds is severely limited in the case of dealer property located in the U.S. because income from the sale of U.S. real estate, if earned by a non-U.S. corporation, would be subject to U.S. federal income tax at the corporate level. Therefore, the blocker corporation strategy is ineffective in the case of U.S. dealer property. Furthermore, structuring techniques used in the case of debt-financed income from real estate, described below, are also ineffective in the case of dealer property. Therefore, all else being equal, tax-exempt entities may be resistant to acquiring interests in real estate funds that intend to invest in dealer property located in the U.S. to any significant extent.

In the case of the second source of income potentially subject to the UBIT (namely debt-financed income from rental property), by complying with certain technical requirements, a real estate fund can ensure that such debt-financed income is not subject to the UBIT in the hands of pension plans, educational institutions, educational

41 See supra note 34 and accompanying text.
42 See I.R.C. § 897. For further discussion of this provision, see Richard L. Kaplan, Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate, 71 Geo. L.J. 1091 (1982-1983). By contrast, a real estate fund could successfully employ a non-U.S. blocker corporation strategy in the case of dealer property located outside the U.S. See Nugent, supra note 34, at 412 - 13. 43 A real estate fund might set up a subsidiary U.S. corporation to hold the U.S. dealer property and the subsidiary corporation might be financed, in part, with debt owed to the real estate fund. Because interest income, like dividend income, is generally not subject to the UBIT, income allocated by such a real estate fund to tax-exempt investors would generally not be subject to the UBIT. Moreover, by financing the subsidiary corporation, in part, with debt, the entity-level tax imposed on the subsidiary corporation can be reduced as a result of deductible interest payments made by the subsidiary corporation. However, as a result of various limits on the extent to which income can be reduced by interest payments, some entity-level tax will still be imposed. For example, if the corporation is too highly-levered, some of the debt may be treated as, in fact, equity for U.S. tax purposes. See, e.g., Bauer v. Comm’r, 748 F. 2d 1365 (9th Cir. 1984); Schnitzer v. Comm’r, 13 T.C. 43 (1949); Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967); John Lizak, Inc. v. Comm’r, 28 T.C.M. 804 (1969). Furthermore, earnings stripping rules can limit the extent to which the subsidiary would be allowed to deduct interest. See I.R.C. § 163(j).
endowments, and certain other specific types of tax-exempt investors. Complying with the technical requirements that allow debt-financed income from real estate to be earned UBIT-free by certain tax-exempt investors may be incompatible with business objectives of the real estate fund. In that case, the real estate fund could form a real estate investment trust (a “REIT”) through which tax-exempt investors would hold an interest in debt-financed real estate. A REIT is generally treated as a corporation for U.S. federal income tax purposes. However, unlike an ordinary corporation, a REIT is entitled to deduct dividends that it pays to its shareholders for purposes of computing the REIT’s income that is subject to U.S. income tax at the REIT level. Therefore, unlike an ordinary corporation, a REIT can avoid entity-level tax. Because a REIT is generally treated as a corporation for U.S. income tax purposes, income earned by tax-exempt shareholders as a result of investing in a REIT will generally be dividend income and capital gain income that is exempt from the UBIT, regardless of the underlying activities of the REIT and regardless of amounts borrowed by the REIT. Therefore, in a similar manner to the blocker corporation strategy described above, a REIT can convert what would otherwise be debt-financed income from real estate, potentially subject to the UBIT, into income that has been cleansed of its UBIT-taint, without incurring an additional corporate-level tax. The tax law does impose some limit on a REIT’s UBIT-blocking capabilities. In particular, if the ownership of a REIT is overly concentrated in the hands of pension plans, any such plan that owns a significant interest in the REIT will be subject to the UBIT.

44 See I.R.C. § 514(c)(9). For a description of the technical requirements, see supra note 34.
45 Section 512(b) of the Internal Revenue Code lists certain types of passive income generally exempt from the UBIT. Included on the list is capital gain income. I.R.C. § 512(b)(5). Gain from the sale of dealer property is not capital gain income. Moreover, gain from the sale of dealer property would be income from a trade or business. Therefore, gain from the sale of dealer property, unless it is related to the tax-exempt entity’s exempt purpose, is subject to the UBIT, regardless of whether or not it is debt-financed.
46 For a description of commonplace business terms that might be incompatible with complying with these technical requirements, see Nugent, supra note 34, at 399 – 408.
47 Id. at 413 - 14.
48 See I.R.C. § 857(b).
49 This is true assuming that the tax-exempt shareholder does not finance its acquisition of shares in the REIT with debt.
51 See supra notes 37 to 38 and accompanying text.
effectively to the same extent that it would be subject to the UBIT if it directly earned the underlying income of the REIT.\textsuperscript{52} However, these pension-held REIT rules do not present a serious obstacle for many real estate funds that, because of their investor pool, are able to avoid the ownership concentration threshold. The REIT strategy is unavailable in the case of dealer property, however, because gain from the sale of dealer property owned by a REIT would be subject to 100\% tax at the REIT level (as opposed to 35\% tax under the UBIT if held through a partnership).\textsuperscript{53}

3. Private Equity Funds

As a result of the potential sources for UBIT liability described above, a tax-exempt investor may hesitate to invest in a private equity fund without some assurance from the fund sponsor that the fund will invest mainly in underlying businesses treated as corporations for US tax purposes and that the fund will limit the amount of debt used to acquire such businesses.\textsuperscript{54} If the private equity fund holds only interests in businesses that are treated as corporations for US tax purposes, a tax-exempt investor in the fund will not be subject to the UBIT on income earned from its investment, provided that the private equity fund does not finance its acquisition of the corporations with debt.\textsuperscript{55} In such a case, however, the tax-exempt investor will indirectly bear its proportionate share of the economic burden of any entity-level corporate tax paid by the businesses in which the private equity fund invests.\textsuperscript{56}

\textsuperscript{52} See I.R.C. § 856(h).
\textsuperscript{53} See I.R.C. § 857(b)(6).
\textsuperscript{54} See, e.g., James H. Lokey and Donald E. Rocap, Selected Tax Issues in Structuring Private Equity Funds, 841 PLI/TAX 741, 782 - 85 (2008). See also Victor Fleischer, The Rationale Exuberance of Structuring Venture Capital Start-Ups, 57 Tax L. Rev. 137, 158 – 59 (2003) (suggesting that the large portion of capital supplied to private equity funds by tax-exempt investors may offer a partial explanation for why start-up businesses are often structured as corporations for tax purposes).
\textsuperscript{55} This is the case provided that the tax-exempt investor does not finance its acquisition of an interest in the private equity fund with debt.
\textsuperscript{56} In the case of any type of fund, a tax-exempt investor might loan money to the fund rather than invest as a partner. If a tax-exempt investor structures its investment in a fund in a manner that is treated as debt rather than equity for U.S. tax purposes, the tax-exempt investor can earn UBIT-exempt interest income from the fund, regardless of the activities of the fund. See I.R.C. § 512(b)(1) (providing that interest is generally not subject to the UBIT). However, because an interest that is, in form, debt but, in substance, equity (because, for example, it provides for unlimited upside potential) will be treated as equity for tax purposes, the tax-exempt investor’s ownership of the fund could not be economically the same as an equity position in the fund without being treated as equity (rather than debt) for tax purposes.
II. Objectives of the Current System

Before proceeding with a discussion of reforms proposed by Congress and alternative reforms proposed by this paper, some background on the policy objectives of the UBIT and the debt-financed income rules is necessary. Because this paper focuses on the need to reform the rules to reduce distortions, the goal of mitigating distortions will be discussed first. Next, all other possible objectives of imposing the UBIT will be discussed so that it can later be shown that the reforms proposed by this paper will not subvert any of these other possible objectives. Other possible objectives of imposing the UBIT on non-debt-financed income include: (1) avoiding unfair competition, (2) preventing erosion of the corporate tax base, (3) preventing managerial diversion, (4) encouraging liability insulation, (5) preventing over-subsidization of tax-exempt entities, and (6) subjecting all income unrelated to an entity’s tax-exempt purpose to at least one level of tax. Possible objectives of the debt-financed income rules include: (1) preventing over-subsidization of tax-exempt entities and (2) preventing certain sale-leaseback transactions viewed as abusive. Each objective is described in turn below.

a. Mitigating Distortions

One potential goal served by the UBIT is eliminating certain distortions that would exist in a world without the UBIT, given that there is a corporate income tax. In particular, as a result of the existence of the corporate income tax, the UBIT is necessary in order to prevent a tax-exempt entity from shifting resources away from widely-held corporations and towards business ventures controlled by the tax-exempt entity in situations in which the pre-tax return accruing to resources used by the widely-held corporation is greater than the pre-tax return accruing to resources used by a business controlled by the tax-exempt entity.

57 The objective of mitigating distortions was not discussed in the legislative history surrounding the enactment of the UBIT. However, it has been suggested by scholars. See, e.g., John D. Colombo, Commercial Activity and Charitable Tax Exemption, 44 WM. & MARY L. REV. 487, 538 - 39 (2002); Henry B. Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 VA. L. Rev. 605, 614 - 17 (1989).

58 There are a variety of reasons why any particular widely-held corporation might be able to generate a higher pre-tax return with a given amount of resources than any particular business entity controlled by a tax-exempt organization. One reason might be that the widely-held corporation is better managed because the managers of the widely-held corporation own stock or stock options and therefore have an incentive to maximize profits, whereas the tax-exempt organization cannot issue shares and therefore its managers may lack a profit-maximizing incentive. See, e.g., Hansmann, supra note 57, at 616 - 17.
This potential distortion can be more fully demonstrated as follows. Assume that a tax-exempt entity is presented with two alternative ways in which it can invest its resources. One option is to invest passively in Kraft Foods, Inc., a publicly traded corporation. Assume Kraft Foods could use the amount invested by the tax-exempt entity to generate, on a pre-tax basis, a return of 20%. If Kraft Foods is subject to a 35% entity level tax and the tax-exempt entity is not subject to any taxes on dividends paid by Kraft Foods or gain from sale of stock in Kraft Foods, after taxes, resources invested in Kraft Foods would generate a return of 13%. The other potential use of the tax-exempt entity’s resources is investment in a macaroni producing business wholly-owned by the tax-exempt entity, along the lines of the Mueller Macaroni Company formerly owned by New York University’s law school. Assume resources invested in the wholly-owned macaroni producing business would yield a pre-tax return of 15%, but assume that an investment in the wholly-owned macaroni producing business is, in terms of risk and other factors, otherwise equivalent to an investment in Kraft Foods. Absent the UBIT, on an after-tax basis, an investment in the wholly-owned macaroni producing business would generate a return of 15%. Therefore, absent the UBIT, the tax-exempt entity would invest its resources in the wholly-owned business even though it produces a lower pre-tax return than an alternative, comparable business.

This resource allocation would be less than optimal because an investment of resources in Kraft Foods would generate a greater amount of wealth for society as a whole than an investment in the tax-exempt entity’s wholly-owned business. $100 invested in Kraft Foods for one year generates $13 of profit for the tax-exempt entity and $7 of tax revenue. This total $20 profit is greater than the profit ($15) generated by an investment of $100 for one year in the wholly-owned macaroni producing business. Moreover, if $2 of the additional profit earned from an investment in Kraft Foods were redistributed from the Internal Revenue Service to the tax-exempt entity, an investment of $100 in Kraft Foods for one year would make some persons (the beneficiaries of the additional tax revenue) better off without making the tax-exempt entity worse off. Resource allocation would, therefore, be improved if the funds were invested in Kraft Foods rather than the wholly-owned business.

Once the UBIT is taken into account, an investment in the wholly-owned macaroni producing business would generate an after-tax return of 9.75%, lower than the 13% after-tax return generated by an investment in Kraft Foods. Consequently, the tax-exempt entity would invest in Kraft Foods, and, as a result of the UBIT, the tax-exempt entity

59 See infra note 61.
allocates its resources in a way that generates more wealth for society by investing in the business that generates a higher pre-tax return.

However, imposing the UBIT in its current form to prevent the potential distortion described above causes new distortions to arise, including the distortion identified by this paper. In particular, as a result of the current state of the law regarding tax treatment of a tax-exempt entity’s investment income, a tax-exempt entity’s investment portfolio may be biased towards passive holdings in partnerships that generate income not subject to the UBIT and away from passive holdings in partnerships that generate income that is subject to the UBIT.

b. Other Objectives of Imposing the UBIT on Non-Debt-Financed Income

Because this paper focuses on the need to reform the rules to reduce distortions that influence investment decisions made by tax-exempt entities, the goal of mitigating distortions was discussed first. Now, all other possible objectives of imposing the UBIT will be discussed, starting with other possible goals of imposing the UBIT on non-debt-financed income. It will later be shown that the proposed reforms will not subvert any of these other possible objectives.

i. Avoiding Unfair Competition

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60 For example, as Professor Rose-Ackerman argued, because the UBIT is not imposed on income generated from a trade or business that is related to a tax-exempt entity’s exempt purpose, the UBIT could encourage too much investment by a tax-exempt entity in businesses related to its exempt purpose. Susan Rose-Ackerman, Unfair Competition and Corporate Income Taxation, 34 STAN. L. REV. 1017 (1982). Professor Rose-Ackerman’s proposed remedy was repeal of the UBIT. Others criticized Professor Rose-Ackerman’s proposal to repeal the UBIT on the grounds that a repeal of the UBIT would result in the distortions that the UBIT can prevent. See, e.g., Hansmann, supra note 57, at 614 - 17. Instead of simply repealing the UBIT, it has been suggested that an optimal allocation of capital by tax-exempt entities among (i) related wholly-owned businesses, (ii) unrelated wholly-owned businesses and (iii) passive investment in corporate equity could be achieved by either (1) repealing the UBIT and integrating the corporate tax system in such a way that tax-exempt entities do not bear, directly or indirectly, tax liability with respect to investment in corporate equity or (2) leaving the corporate tax system in place but modifying the UBIT so that, instead of distinguishing between related and unrelated businesses, the UBIT applied to income from all commercial enterprises. See, e.g., Hansmann, supra note 57, at 618 (discussing alternative (1)); Colombo, supra note 57, at 538 - 41 (discussing alternative (2) as a possibility to consider if alternative (1) is viewed as not feasible). See also James Bennett and Gabriel Rudney, A Commerciality Test to Resolve the Commercial Nonprofit Issue, 36 TAX NOTES 1095 (September 1987).
Congress originally enacted the UBIT largely as a means to combat the evil of “unfair competition” that results when tax-exempt entities manufacture products and supply services that compete for market share with products and services sold by entities that are subject to tax and tax-exempt entities have an advantage based solely on their tax exemption.\footnote{Prior to the adoption of the tax, the Mueller Macaroni Company was wholly-owned by New York University’s law school. The Mueller Macaroni Company manufactured and sold macaroni and related products, and its profits accrued solely for the use and benefit of NYU’s law school. Under the law in effect prior to the enactment of the UBIT, the Third Circuit Court of Appeals held that the profits of Mueller Macaroni would not be subject to U.S. federal income tax because the profits of Mueller Macaroni exclusively benefited NYU’s law school and the law school itself was a tax-exempt organization. See C.F. Mueller Co. v. Comm’r, 190 F.2d 120 (3d Cir. 1951). Motivated by a concern that businesses, such as Mueller Macaroni, run by tax-exempt entities would compete unfairly with taxable enterprises, Congress enacted the UBIT to impose tax upon the profits of Mueller Macaroni and similar businesses. Representative John Dingell, when referring to the ownership by NYU’s law school of the Mueller Macaroni Company, warned that, without the UBIT, “the macaroni monopoly will be in the hands of the universities…” Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means, 81st Cong. 580 (1950) (statement of Rep. John Dingell). See also Treas. Reg. § 1.513-1(b).} In addition to reflecting the concern that tax-exempt entities would undercut prices charged by their taxable competitors (or outbid their taxable competitors for labor and capital used in their business) solely because of a tax-based advantage, the legislative history alludes to a concern that tax-exempt entities that earned the same amount of pre-tax income as their equally successful taxable counterparts would nevertheless be able to expand more rapidly with the use of greater after-tax profits.\footnote{See, e.g., S. Rep. No. 81-2375 at 28 (1950) (stating that the tax-exempt status of tax-exempt entities “enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes”).} Finally, Congress provided that certain types of passive income (such as dividend income, interest income, rental income, capital gain income and royalty income) would not constitute income subject to the UBIT in part because Congress apparently held the view that passive income did not present a threat of unfair competition.\footnote{See S Rep No 2375, 81\textsuperscript{st} Cong, 2d Sess at 30-31 (1950) (“Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are ‘passive’ in character and are not likely to result in serious competition for taxable businesses having similar income.”).}

Despite references in the legislative history to the unfair competition concern, the likelihood that tax-exempt entities would compete unfairly with taxable competitors either by pricing taxable competitors out of the market or by engaging in more rapid expansion...
has been called into serious question by economists and legal scholars. Regarding rapid expansion, others have observed that, if a taxable entity is able to produce a product or provide a service as efficiently as a tax-exempt competitor, it should be able to expand just as quickly as the tax-exempt competitor by borrowing funds or raising additional equity to compensate for its lower after-tax profits.64

Regarding pricing, others have posited that, absent a tax on any income whatsoever earned by tax-exempt entities, tax-exempt entities would charge the same prices and bid the same amount for factors of production as their equally efficient taxable competitors that are subject to tax on all income they earn.65 The after-tax return demanded by a tax-exempt entity (or a taxable entity) from any given business venture will depend on the after-tax return the tax-exempt entity (or taxable entity) could earn from an alternative use of its funds. Therefore, as long as the tax-exempt entity is subject to the same rate of tax on income earned from a given business venture and alternative uses of its funds, and the taxable entity is, likewise, subject to the same rate of tax on income earned from both sources, the tax-exempt entity will charge the same prices and bid the same amount for factors of production as its equally efficient taxable competitor.66 Thus, contrary

66 For example, assume that a taxable entity (“T”) and a tax-exempt entity (“TE”) are each deciding how much to pay for a piece of equipment that, when used in either of their businesses, would be expected to generate $142.85 of pre-tax income one year after acquisition. The fact that the entities expect to earn the same amount of pre-tax income from use of the equipment shows that the two entities are equally efficient users of the equipment, and, therefore, absent an “unfair” tax-related advantage, should be willing to pay the same amount for the equipment. Furthermore, assume that each of T and TE have the opportunity to make an equally risky alternative investment that would generate an expected pre-tax return of 42.85% over the year. In
to the fears that motivated the enactment of the tax, in a world without the UBIT, tax-exempt entities do not necessarily have a competitive advantage as a result of their tax treatment. Moreover, imposing the UBIT may create potential for unfair competition that did not exist under the system in place prior to enactment of the tax.  

Finally, as mentioned above, Congress exempted certain types of passive income (such as dividend income) from the UBIT based, in part, on the belief that passive income did not present a threat of unfair competition. In the case of dividend income, this view arguably has some merit. If a tax-exempt entity runs an unrelated business directly, Congress might have been concerned that, if the business was not subject to tax, the tax-exempt entity would sell its products at lower prices than taxable competitors, driving taxable competitors out of business. However, if multiple tax-exempt entities purchase shares of stock in a publicly traded corporation, it is unlikely, to say the least, that the corporation would take advantage of the lower pre-tax rate of:

addition, assume that T is subject to 30% tax on the income from the equipment or from the alternative investment. Likewise, TE is subject to 0% tax on the income from the equipment or from the alternative investment. As a result, T’s after-tax expected return from the alternative investment is 30%, and TE’s after-tax expected return from the alternative investment is 42.85%. Because an investment in the equipment and the alternative investment are equally risky, when determining how much they would be willing to bid for the equipment, each of T and TE would be willing to bid up to the amount that would result in an expected after-tax return equal to the expected after-tax return from the alternative investment. Consequently, T would be willing to bid up to $100 because that would generate an expected pre-tax return of 42.85% and an expected after-tax return of 30% from the equipment. Likewise, TE would be willing to bid up to $100 because that would generate an expected pre-tax return of 42.85% and an expected after-tax return of 42.85% from the equipment. Because TE would be willing to bid no more than what T would be willing to bid, TE’s universally lower tax rate does not grant TE any competitive advantage.

67 See, e.g., Knoll, supra note 64, at 871. In the context of the hypothetical situation presented in note 66 supra, for example, assume the income generated by the equipment is not subject to the UBIT (because the equipment is used in a business related to the tax-exempt entity’s exempt purpose), while the income from the alternative investment is subject to 30% tax under the UBIT. In that case, the taxable entity would still be willing to bid only $100 for the equipment. However, the tax-exempt entity would be willing to bid $109.88 for the equipment, since the tax-exempt entity would only require an after-tax (and pre-tax) return from the equipment of 30% (since that is the after-tax return generated by the alternative investment). If the assumption was reversed so that the income generated from the equipment was subject to the UBIT while the income from the alternative investment was not subject to the UBIT, the taxable entity would be willing to outbid the tax-exempt entity with respect to the equipment.

68 See supra note 63 and accompanying text.

69 As discussed above, however, this concern may not have been justified.
return that might be demanded by its tax-exempt shareholders (as a consequence of not paying tax on dividends) in order to sell its products at lower prices than an otherwise identical competitor owned by predominately taxable shareholders.\textsuperscript{70}

\textbf{ii. Preventing Erosion of the Corporate Tax Base}

The UBIT was enacted, in part, to forestall the dwindling corporate tax revenues that would result in a world without the UBIT in which tax-exempt entities ultimately acquired and ran all active businesses.\textsuperscript{71} In other words, the UBIT was intended to serve the purpose of preventing erosion of the corporate tax base.\textsuperscript{72}

\textbf{iii. Preventing Managerial Diversion}

As Professor Colombo has observed, one function that may be served by the UBIT is discouraging tax-exempt entities from spending too much time and effort engaged in commercial enterprises, which could detract from their tax-exempt purposes.\textsuperscript{73} Consistent with this aim, Congress may have explicitly excepted dividends, interest, rent, and other types of passive income from the UBIT in part because investing in assets that generate passive income requires less managerial time and may be less likely to lead to potential conflicts with

\textsuperscript{70} For further discussion, see infra notes 120 to 122 and accompanying text. While the lack of a competitive threat may be conceivable in the case of dividends, it is not entirely clear why Congress believed that certain other types of income explicitly exempted from the UBIT (for example, rent and royalties) posed less of a threat of unfair competition than active business income. \textit{See, e.g.},\textsc{ Stephen Schwarz, Federal Income Taxation of Investments by Nonprofit Organizations: Beyond a Primer} 47 (2000); Bittker & Rahdert, \textit{supra} note 65, at 319; Hansmann, \textit{supra} note 57, at 626; Kaplan, \textit{supra} note 14, at 1435, 1466; Ethan G. Stone, \textit{Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax}, 54 Emory L.J. 1475, 1496 - 1502 (2005); Note, \textit{Criticized Uses of Federal Tax Exemption Privileges by Charitable Foundations and Educational Institutions}, 98 U. Pa. L. Rev. 696, 706 (1950); Note, \textit{The Macaroni Monopoly: the Developing Concept of Unrelated Business Income of Exempt Organizations}, 81 Harv. L. Rev. 1280, 1283 - 84 (1968).

\textsuperscript{71} This sentiment is reflected in the statement by Representative John Dingell, that, without the UBIT, “Eventually all the noodles produced in this country will be produced by corporations held or created by universities....” Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means, 81st Cong. 580 (1950) (statement of Rep. John Dingell). For further discussion regarding the ownership by New York University’s law school of Mueller Macaroni to which this statement refers, see \textit{supra} note 61.

\textsuperscript{72} \textit{See, e.g.}, Colombo, \textit{supra} note 57, at 532 - 34; Hansmann, \textit{supra} note 57, at 621 - 23.

\textsuperscript{73} Colombo, \textit{supra} note 57, at 534 - 38. \textit{See also} Note, \textit{The Macaroni Monopoly: the Developing Concept of Unrelated Business Income of Exempt Organizations}, 81 Harv. L. Rev. 1280, 1283 (1968).
the entity’s tax-exempt purpose. Indeed, this may be what is meant by the statement in the legislative history that such passive types of income were not subject to the UBIT because such types of income had “long been recognized as a proper source of revenue for educational and charitable organizations and trusts.” 74

iv. Encouraging Liability Insulation

Professor Colombo, although not arguing that it is a convincing explanation for the way in which the UBIT is currently designed, observes that one potential concern that might arise when tax-exempt organizations engage in commercial enterprises is that such activity could subject charitable assets to the risks of non-charitable enterprises. 75

v. Preventing Over-Subsidization of Tax-Exempt Entities

Preventing over-subsidization of tax-exempt entities may have been a factor motivating Congress’s decision to enact the UBIT. If no income of tax-exempt entities was subject to tax, the subsidy granted to tax-exempt entities would not necessarily bear any relation to the degree of public support for tax-exempt entities or the amount of good works provided by tax-exempt entities. 76

Under current law, tax-exempt entities are, however, subsidized in a number of ways. Tax-exempt entities earn tax-free income from trades or businesses related to their exempt purposes, and many commercial enterprises can be classified as related businesses. 77 In addition, certain types of passive income earned by tax-exempt entities

74 See S Rep No 2375, 81st Cong, 2d Sess at 30-31 (1950). See also Suzanne Ross McDowell, Taxing Leveraged Investments of Charitable Organizations: What is the Rationale?, 39 CASE W. RES. L. REV. 705, 725 (1988) (“[The exclusion of passive income from the UBIT] has also been supported on the ground that it appropriately encourages exempt organizations to limit their level of participation in income-producing activities to passive investments, which are seen as less of a distraction from the organization’s exempt purposes than is active participation in business enterprises.”).
75 Colombo, supra note 57, at 544 - 46.
76 Id. at 541 - 44.
77 Id. at 531 (“To take a fanciful hypothetical, one suspects that if New York University’s law school implemented clinical legal education offerings related to being corporate legal counsel, and directly operated Mueller Macaroni as a clinical or externship placement vehicle for students, such a business would no longer be ‘unrelated’ under the UBIT”). For further discussion regarding the ownership by New York University’s law school of Mueller Macaroni to which this statement refers, see supra note 61.
from assets that are not debt-financed are not subject to tax. Therefore, the existing subsidy granted to a tax-exempt entity is not limited to an exemption from tax of amounts earned directly from carrying out a tax-exempt entity’s exempt purpose. Moreover, as Professor Colombo and Professor Hansmann have observed, there is no reason to believe that, by drawing the lines where it did, Congress provided tax-exempt entities with a subsidy of precisely the correct amount.

vi. Subjecting All Income Unrelated to an Entity’s Tax-Exempt Purpose to at Least One Level of Tax

Basing his argument on the current design of the tax system, Professor Schwarz has argued that the purpose of the UBIT is to impose at least one level of tax on all income earned by tax-exempt entities that is unrelated to their tax-exempt purpose. Dividends, therefore, are exempt from the UBIT because they are generally paid out of earnings of corporations that have already been subject to corporate level tax.

When a tax-exempt entity invests in a business treated as a partnership for tax purposes, on the other hand, the tax-exempt entity is subject to the UBIT to the extent that underlying income of the partnership allocated to the tax-exempt partner would be subject to the UBIT if earned directly. This treatment is consistent with the goal of taxing all unrelated income earned by a tax-exempt entity at least once since a partnership, unlike a corporation, is not subject to tax at the entity level.

c. Objectives of the Debt-Financed Income Rules

The debt-financed income rules have been justified on slightly different grounds than the rules that impose the UBIT on non-debt-financed income, as discussed below.

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78 Indeed, some have suggested that a concern about over-subsidization might warrant taxing passive income earned by tax-exempt entities. See, e.g., George Break & Joseph A. Pechman, Relationship Between the Corporation and Individual Income Taxes, 28 NAT’L TAX J 341, 344 (1975). However, others have observed that the additional subsidy provided by exempting passive income might be viewed as desirable. See, e.g., McDowell, supra note 74, at 725 (“The passive income exception also assists charitable organizations in gaining some degree of independence, and gives them the ability to weather unforeseen events in lean economic times.”)

79 Colombo, supra note 57, at 541 - 44; Hansmann, supra note 57, at 621.

80 Schwarz, supra note 70, at 46 – 47, 112, 134 - 35. See also Ellen P. Aprill, Lessons from the UBIT Debate, 45 TAX NOTES 1105, 1110 (November 1989).

81 I.R.C. § 512(c)(1).

82 Schwarz, supra note 70, at 91 - 92.
i. **Preventing Over-Subsidization of Tax-Exempt Entities**

Like the rules imposing the UBIT on non-debt-financed income, the debt-financed income rules might represent an attempt to prevent over-subsidization of tax-exempt entities. Regarding the debt-financed income rules, the Treasury Department described one potential purpose of the rules as the prevention of the ability of tax-exempt entities, “to grow altogether without reference to the amount of contributions or membership fees which they receive from the public, or the income produced by investment of their own funds”.

However, as is true in the case of imposing tax on some active business income earned by tax-exempt entities, there is no convincing reason to believe that the current debt-financed income rules result in precisely the right amount of subsidy. For one thing, there is no reason to believe that the subsidy resulting from exempting passive income that is not debt-financed is of the appropriate magnitude. Secondly, as others have observed, while it is true that acquiring debt-financed assets can potentially allow tax-exempt entities to earn more income, it is equally true that investing in any risky asset could potentially produce a higher return. Yet, passive income received from many highly risky investments is not subject to the UBIT.

Thirdly, given that the return earned by a tax-exempt shareholder that invests in a corporation can be higher if the corporation borrows money, it is not clear why debt-financed assets owned by a partnership cause a portion of income allocated to a tax-exempt partner to be subject to the UBIT while debt-financed assets owned by a corporation do not cause any dividend income received by a tax-exempt shareholder to be subject to the UBIT.

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84 See, e.g., McDowell, *supra* note 74, at 730; LePree, *supra* note 37, at 844.
86 *Id.* at 656. While it is true that the corporate level tax will dampen the extent to which leverage incurred by a corporation can magnify positive shareholder returns, leverage can, nevertheless, increase positive shareholder returns to some extent. Furthermore, after taking into account the manner in which the UBIT is applied to debt-financed income from a partnership, the extent to which leverage increases shareholder returns can exceed the extent to which leverage increases partner returns. For example, assume a tax-exempt entity invests $100 in a partnership in exchange for a 10% equity interest in the partnership, and the partnership borrows $500 and uses the $500 plus $1000 of equity to acquire an asset for $1500. Assume that the terms of the debt provide for 10% interest, compounded annually. Further, assume that the partnership sells the asset after 3 years for $3000. $665.50 must be used to repay principal and accrued interest on the debt, leaving $2334.50 for distribution to the partners (or $233.45 for distribution to the tax-
ii. **Preventing Certain Sale-Leaseback Transactions**

While there is some suggestion in the legislative history that the debt-financed income rules may have been intended to prevent over-subsidization, the legislative history makes clear that the debt-financed income rules were intended largely as a measure to prevent certain sale-leaseback transactions in which tax-exempt entities purchased assets (often acquired with the use of debt) and leased them exempt partner with respect to its 10% interest in the partnership). If, on the other hand, the partnership borrowed no money and simply used $1000 to acquire an asset that doubled in value over 3 years, the partnership would only have $2000 to distribute to its partners after 3 years (or $200 to distribute to the tax-exempt partner with respect to its 10% interest). For comparison purposes, assume a tax-exempt entity invests $100 in a corporation in exchange for a 10% equity interest in the corporation, and the corporation borrows $500 and uses the $500 plus $1000 of equity to acquire an asset for $1500. Assume that the terms of the debt provide for 10% interest, compounded annually. Further, assume that the corporation sells the asset after 3 years for $3000. $665.50 must be used to repay principal and accrued interest on the debt, leaving $2334.50 for distribution, prior to payment of corporate-level tax. For simplicity, if it is assumed that the corporation is subject to 35% tax and it is assumed that all interest is deductible in year 3, after payment of taxes, the corporation will have $1867 left to distribute to its shareholders (or $186.70 for distribution to the tax-exempt shareholder with respect to its 10% interest). If, on the other hand, the corporation borrowed no money and simply used $1000 to acquire an asset that doubled in value over 3 years, the corporation would only have $2000 to distribute to its shareholders after 3 years before taking into account taxes or $1650 after taking into account taxes (or $165 to distribute to the tax-exempt partner with respect to its 10% interest). Thus, in the case of the partnership, in this example, use of debt increases the amount distributed to the tax-exempt partner from $200 to $233.45, while, under similar facts in the case of a corporation, use of debt increases the amount distributed to the tax-exempt shareholder from $165 to $187.70. While it is true that the increase is greater in the case of a partnership than a corporation, it is not greater by a sufficient amount so that imposing 35% UBIT on the debt-financed portion of income from the partnership would equalize the additional after-tax return resulting from use of leverage. In particular, if the underlying income of the partnership is passive income, none of the $200 received from the unlevered partnership would be subject to the UBIT. However, the amount of UBIT imposed on income from the partnership that uses leverage would be approximately $15.57 (35% tax imposed on the one-third portion of the tax-exempt entity’s income (133.45 in total) that is debt-financed). None of the dividends received from either the levered or the unlevered corporation would be subject to the UBIT. As a result, after the UBIT is taken into account, use of leverage increases the amount received from the corporation by $22.70 (or 14%) (from $165 to $187.70), while the use of leverage increases the amount received from the partnership by only $17.88 (or 9%) (from $200 to $217.88).

*See supra* note 83 and accompanying text.
back to their taxable former owners. However, as many have observed, the debt-financed income rules are much broader than what would have been necessary to discourage the sale-leaseback transactions. The use of debt financing by tax-exempt entities to acquire the assets was not a necessary component of the perceived abuse and merely served as a means of expanding the magnitude of the perceived abuse (by allowing tax-exempt entities to acquire more assets).

III. Congressional Proposals under the Stop Tax Haven Abuse Act

As described above, many hedge funds employ a structure using “blocker corporations” in order to minimize tax liability incurred by tax-exempt investors. In particular, a hedge fund forms a non-U.S. entity in a tax haven jurisdiction (a “blocker corporation”) and elects to treat the entity as a corporation for U.S. tax purposes. Tax-exempt entities invest through the blocker corporation and, consequently, earn dividend income and capital gain income, exempt from the UBIT, as a result of their investment. Furthermore, the blocker corporation, as a non-U.S. person, is generally not subject to U.S. tax at an entity level on the types of income earned from investments made by a typical hedge fund.

A provision of the “Stop Tax Haven Abuse Act” would effectively eliminate the ability of hedge funds to use this blocker corporation strategy. In particular, Section 103 of the Act provides that certain non-U.S. corporations that are managed or controlled, directly or indirectly, primarily in the United States (which would likely include blocker corporations used by hedge funds) would be treated as US domestic corporations. As a consequence, blocker corporations generally would be subject to US tax at an entity level on all of their income, and the use of blocker corporations would no longer represent a tax-efficient means of minimizing UBIT liability incurred by tax-exempt investors as a result of investing in hedge funds.

89 See, e.g., LePree, supra note 37, at 841; Howard J. Barnet Jr., The Application of the Unrelated Business Tax to Securities and Other Investment by Tax-Exempt Organizations, 823 PLI/Tax 573, 597 (2008); Weigel, supra note 85.
90 See, e.g., Weigel, supra note 85, at 646 - 47.
91 See supra notes 37 to 40 and accompanying text.
93 More recently, Jeffrey Goldstein, during a hearing regarding his nomination to serve as the Treasury’s undersecretary for domestic finance, stated that he would be willing to work with legislators on the issue of the use of offshore blocker corporations by investment funds. See, “Treasury Nominee Goldstein
Congressional criticism of the use of blocker corporations to minimize UBIT is misguided. The likely result of enactment of legislation proposed by Congress would be increased distortion in investment decisions made by tax-exempt entities, without any offsetting benefits in the form of higher tax revenue or a more fair tax system. The legislation would not result in a more fair tax system because it would tax differently very similar investments. The proposal would be unlikely to generate higher tax revenue because tax-exempt entities would simply shift investment away from hedge funds that use leverage that is captured by the debt-financed income rules and towards hedge funds that do not use leverage that results in UBIT liability. Finally, this investment shift would result in a less optimal allocation of capital to the extent that use of leverage that is encompassed by the debt-financed income rules may be preferable for non-tax reasons in some circumstances.

IV. Proposed Reforms: Adoption of Control as the Relevant Test

In lieu of reforms suggested by Congress, this paper proposes reforms that would allow tax-exempt entities to invest passively in partnerships without incurring liability under the UBIT, even in the absence of tax structuring. Compared to current law, the reforms proposed by this paper would better serve the goal of mitigating distortions that influence investment decisions made by tax-exempt entities. The reforms proposed by this paper would not subvert any of the other goals of taxing income earned by tax-exempt entities. Finally, the reforms proposed by this paper would modernize the law in acknowledgement of the way in which investment holdings by tax-exempt entities have changed since the rules were originally adopted.

As discussed above, current law generally does not aim to tax investment income earned by tax-exempt entities. However, while a tax-exempt investor is generally not subject to tax on income earned


As discussed above, not all means by which hedge funds leverage their returns in an economic sense will constitute use of leverage for purposes of the debt-financed income rules. See supra note 33. For example, the Internal Revenue Service has ruled that income subject to the UBIT under the debt-financed income rules does not result when a tax-exempt entity sells publicly-traded stock short through a broker. Therefore, if Congressional proposals were adopted, tax-exempt entities would simply shift investment away from hedge funds that borrow money to finance acquisition of assets and towards hedge funds that implicitly use leverage not captured by the debt-financed income rules.

This is true as long as the income is not debt-financed. See supra notes 18 to 21 and accompanying text.
from an entity treated as a corporation for tax purposes, a tax-exempt investor is subject to tax on certain types of income earned from entities treated as partnerships for tax purposes.\footnote{96} This could well be an artifact of a time when investment holdings by tax-exempt entities generally did not consist of interests in partnerships, since the UBIT rules were adopted more than a half century ago. Times have changed, as tax-exempt entities now invest substantial sums in hedge funds, real estate funds, and private equity funds.\footnote{97} Yet, the tax law continues to use type of entity as an outdated and inaccurate proxy for whether or not income is investment income. Instead of allowing the form of entity to dictate tax consequences, this paper proposes that the rules be modernized so as to exclude all income that is truly investment income, in any meaningful sense, from the scope of the UBIT. Modernizing the rules will offer the important benefit of better serving the goal of mitigating distortions that influence investment decisions made by tax-exempt entities.

Regarding distortions that exist under current law, because tax-exempt entities are subject to tax on income earned from some real estate funds (and some private equity funds) but not other real estate funds (or other private equity funds), tax consequences can distort investment decisions made by tax-exempt entities. Reforming the rules in a way that results in tax-exempt entities not bearing tax liability on income earned from any typical real estate fund or private equity fund would remove this distortion. Moreover, expanding the scope of what constitutes investment income exempt from UBIT in a way that has the effect of not subjecting income earned from any typical fund to the UBIT can be accomplished by adopting a more meaningful definition of investment income.

A meaningful definition of investment income should be based on policy justifications for exempting investment income from the scope of the UBIT. Two rationales for imposing the UBIT in the first place offer potentially principled reasons for excluding at least certain types of investment income from the UBIT’s scope. These rationales are preventing unfair competition (at least as applied to dividends under current law) and preventing managerial diversion.\footnote{98} For reasons

\footnote{96} See supra notes 25 to 29 and accompanying text.  
\footnote{97} Regarding amounts invested, see supra note 31. For discussion of the increasing importance of private equity funds and hedge funds generally, see LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 222 – 231 (2010).  
\footnote{98} It is also the case that any time the definition of investment income is expanded, the subsidy granted to tax-exempt entities will increase. Therefore, expanding the definition of investment income can, in some sense, impede the goal of restricting the subsidy granted to a tax-exempt entity. However, any attempt to restrict the amount of the subsidy by taxing certain types of income but not other types of income will be arbitrary and will distort investment decisions made by tax-exempt entities. Consequently, if the increased subsidy
described below, expanding the definition of investment income to include income earned by a tax-exempt entity from a partnership would maintain consistency with these rationales as long as the new exemption only applies when (i) the tax-exempt entity has no control over ordinary business decisions made by the partnership and (ii) taxable investors invest a non-trivial amount of capital in the partnership and share in economic returns of the partnership alongside the tax-exempt investor pro rata based on capital invested.

Control, in turn, should be broadly defined to include situations in which the investor has direct control as well as situations in which the investor can likely influence a person who has direct control. Thus, a tax-exempt entity would be treated as lacking control only if the tax-exempt entity invested as a limited partner owning less than 50% of a limited partnership or as a non-managing member owning less than 50% of a limited liability company. In addition, a tax-exempt entity would be deemed to have control if the tax-exempt entity was related to any person who did have control over ordinary business decisions made by the partnership.

The proposed UBIT exemption would not be dependent on the underlying activities of the partnership. Thus, for example, gain from sale of “dealer” property (generally for-sale housing projects such as condominiums) earned by a real estate fund that is treated as a partnership for tax purposes would no longer give rise to UBIT liability for a tax-exempt entity that invests passively in the fund. In addition, debt-financed income earned by any partnership would no longer constitute income subject to the UBIT in the hands of a tax-exempt entity that invests passively in the partnership. Furthermore, a tax-exempt entity that invests passively in a private equity fund treated as a partnership for tax purposes would no longer owe UBIT as a result of active business income earned by the private equity fund.

The reforms proposed above are broader than certain reforms that have been suggested by others. In particular, while previously resulting from expanding the definition of investment income is a concern, rather than limiting the subsidy by taxing certain types of investment income but not other types of investment income, it would be preferable (from the standpoint of mitigating distortions) to limit the subsidy by taxing all investment income at the same rate. See infra note 149 and accompanying text.

99 See infra notes 120 to 123 and 145 and accompanying text.
100 See, e.g., LePree, supra note 37. See also Weigel, supra note 85. Not too long ago, Congress also considered a bill that that would have modified the tax law so that, when a partnership borrowed money to acquire securities or commodities, tax-exempt limited partners in the partnership would not be subject to the UBIT on debt-financed income as a result, provided that certain requirements were met. See H.R. 3501, 110th Cong., 1st Sess. (9/7/07).
suggested reforms would eliminate or modify the rules that subject debt-financed income to the UBIT, the reforms proposed above would generally exempt from the UBIT any income earned by a tax-exempt entity from passive investment in a partnership, not just debt-financed income earned from such investment. Furthermore, unlike the most recent legislative proposal under the “Stop Tax Haven Abuse Act” that would limit the ability of tax-exempt entities to minimize UBIT incurred as a result of passive investment in partnerships, this paper proposes that the law should be reformed in a way that would allow tax-exempt entities to invest passively in partnerships without incurring liability under the UBIT, even in the absence of tax structuring.

V. Evaluation of Reforms

By subjecting income earned from similar funds to the same rate of tax, the reforms proposed by this paper would better serve the goal of mitigating distortions that influence investment decisions made by tax-exempt entities. In addition, the reforms would not subvert any of the other goals of taxing income earned by tax-exempt entities.

a. Mitigating Distortions

Under current law, a tax-exempt entity’s investment decisions may be biased towards passive holdings in partnerships that generate income not subject to the UBIT and away from passive holdings in partnerships that generate income that is subject to the UBIT. For example, given the choice between, on the one hand, investing in a real estate fund that only acquires rental properties and generates no income subject to the UBIT and, on the other hand, investing in a real estate fund that only builds and sells for-sale housing (i.e. dealer property) generating gain that is all subject to the UBIT, if the real estate funds are otherwise equivalent investments, the tax-exempt entity may prefer the rental property fund even if it generates a lower pre-tax return than the for-sale housing fund. Investing resources in a real estate fund that generates a lower pre-tax return than an otherwise comparable real estate fund that generates a higher pre-tax return is not optimal because investing resources in the latter instead of the former would generate a greater amount of wealth for society as a whole.102

Similarly, investment by tax-exempt entities could be overly directed towards private equity funds that generate less income subject to the UBIT and away from private equity funds that generate more income subject to the UBIT. For example, tax-exempt entities may be discouraged from investing in private equity funds that own active

101 See supra notes 92 to 94 and accompanying text.
102 This is similar to the example described above. See supra note 58 and accompanying text.
operating businesses over a period of time when the businesses earn income instead of private equity funds that yield a return by selling businesses before the businesses begin to generate income. Finally, while current law allows tax structuring that results in tax-exempt entities investing in most hedge funds without incurring liability under the UBIT, if legislation proposed by Congress were adopted, tax-exempt entities might be discouraged from investing in hedge funds that employ leverage that results in UBIT liability even if such funds generate a higher pre-tax return than comparable hedge funds that do not use leverage resulting in UBIT liability.\textsuperscript{104}

One way to cure the distortions arising under current law (which distortions Congress’s proposal would exacerbate) is to adopt the reforms proposed by this paper. If the proposed reforms were adopted, no income generated by any hedge fund, real estate fund, or private equity fund would be subject to the UBIT, and, if the investments are otherwise comparable, the tax-exempt entity would choose among investment options by selecting investments based on pre-tax returns. Two potential objections to the conclusion that the proposed reforms would be desirable from the perspective of reducing distortions are discussed below. In addition, as discussed below,\textsuperscript{105} while alternative reforms could better serve the goal of reducing distortions than the reforms proposed by this paper, these alternative reforms are not politically feasible and may be undesirable. Consequently, the reforms proposed by this paper offer a practical alternative that would represent an improvement compared to current law.

i. Investment by Taxable Investors Compensates for Investment by Tax-Exempt Investors

One might argue that imposing tax on tax-exempt entities with respect to income earned from a fund that sells for-sale housing while not taxing income earned by tax-exempt entities from a fund that holds rental real estate should not, overall, result in a less than optimal allocation of resources because taxable investors, that are taxed on income from both funds, will invest in a manner that compensates for the undersupply of capital to the fund that sells for-sale housing. In particular, if the UBIT causes tax-exempt entities to shift away from for-sale housing funds and towards rental property funds, the resulting increase in supply of capital to rental property funds should cause a decrease in the pre-tax return earned by capital invested in rental

\textsuperscript{103} For a description of the legislation, see supra notes 92 to 94 and accompanying text.
\textsuperscript{104} See supra note 94 and accompanying text.
\textsuperscript{105} See infra notes 158 to 171 and accompanying text.
property funds, and, at the same time, the resulting decrease in supply of capital to for-sale housing funds should cause an increase in the pre-tax return earned by capital invested in for-sale housing funds. When the pre-tax return earned by capital invested in rental property funds falls while the pre-tax return earned by capital invested in for-sale housing funds rises, taxable investors that are taxed on income earned by both types of real estate fund should shift a portion of their investment away from rental property funds and towards for-sale housing funds. If taxable investors represent a sufficiently large fraction of investors in real estate funds, the movement of taxable investors towards for-sale housing funds could compensate for the movement of tax-exempt investors away from for-sale housing funds.

However, taxable investors represent a fraction of investors in real estate funds that is too small for investment decisions by taxable investors to offset investment decisions by tax-exempt investors. For a


107 Even if taxable investors did represent a sufficiently large fraction of investors in real estate funds, their investment decisions might not offset the bias faced by tax-exempt investors. To the extent that rental property funds sell rental properties generating capital gain income, tax considerations could also bias non-corporate taxable investors away from investing in for-sale housing funds and towards investing in rental property funds, since such investors are entitled to beneficial tax rates on long-term capital gain income.

108 And, for that matter, private equity funds. For statistics regarding types of investors, see, for example, www.blackstone.com/cps/rde/xchg/bxcom/hs/limitedpartners_about.htm (setting forth the percentage of capital committed to investment funds sponsored by Blackstone as of September 30, 2009 – 54.6% committed by tax-exempt investors, 27.9% committed by taxable investors, and 17.6% committed by non-U.S. investors and fund of funds). Furthermore, in aggregate, as of 2004, tax-exempt investors committed approximately 48% of total capital committed to private equity funds, taxable investors committed approximately 34%, and fund of funds and other investors (for which tax status is unclear) committed the remaining 18%. See Report for Joint Committee on Taxation, “Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I”, 19 -20 (September 4, 2007) available at http://www.jct.gov/x-62-07.pdf. The comparable statistics for venture capital funds were: 63% tax-exempt investors and 37% taxable investors. Id. at 20 – 21. The comparable statistics for hedge funds were more balanced. As of 2006, 48% of capital was invested by investor types that are likely taxable (in particular, individuals and corporations), 29% of capital was invested by tax-exempt investors (pension funds, endowments, and foundations), and the remainder (23%) was invested by fund of funds (whose ultimate investors may be taxable or tax-exempt). Id. at 13.
number of reasons, investors in real estate funds generally must invest a sizeable amount of capital. As a result, while certain wealthy individuals will invest in real estate funds, investment in such a fund is financially out of reach for most individuals in their individual capacity. A large portion of capital is, instead, supplied by institutional investors, the majority of which are pension plans, educational endowments, and certain other tax-exempt entities.

ii. The Proposed Reforms Could Create New, Even Less Desirable Distortions

A second objection might be that, while the proposed reforms ought to cure the particular distortions described above, the proposed reforms might also create new, possibly even less desirable, distortions. These new distortions could present themselves in any one of three ways. First, the proposed reforms could cause tax-exempt entities to allocate capital away from equity in publicly-traded corporations and towards newly untaxed investment in real estate funds that build and sell for-sale housing. Second, the proposed reforms could cause tax-exempt entities to allocate capital away from equity in publicly-traded corporations and towards newly untaxed investment in private equity funds. Third, the proposed reforms could cause tax-exempt entities to allocate capital away from equity in

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109 First, in order for the offering of interests in the fund to qualify as a private offering exempt from certain registration requirements of the Securities Act of 1933, based on Regulation D under Section 4(2) of the Securities Act of 1933, funds will generally seek high net worth investors. Second, most funds in which taxable persons (including the sponsor of the fund) invest will seek to be treated as partnerships for tax purposes. One way in which such funds can ensure that they will not be treated as corporations for tax purposes as a result of the publicly-traded partnership rules discussed below (see infra notes 128 to 134 and accompanying text) is by limiting the number of partners to 100 (see infra note 132). Given that funds will, therefore, often seek to limit the number of investors, funds will have an incentive to require that the amount invested by any given investor is significant.

110 This hesitation is effectively an application of the theory of second best. The theory of second best, in general, posits that removing one obstacle (but not all obstacles) to achieving optimum efficiency does not necessarily result in an improvement in efficiency. See, e.g., Steinberg, supra note 65, at 355; R. G. Lipsey & Kelvin Lancaster, The General Theory of Second Best, 24 REVIEW OF ECONOMIC STUDIES 11, 12 (1956 - 1957); Richard S. Markovits, A Basic Structure for Microeconomic Policy Analysis in Our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics, 1975 WIS. L REV. 950, 953 (1975) (describing the theory of second best as “the proposition that unless one develops an argument to the contrary based on the facts that actually prevail in the relevant context, a situation in which a smaller but still positive number of Pareto imperfections is present is no more likely than not to be allocatively preferable to a situation in which a larger number of Pareto imperfections is present.”)
publicly-traded corporations and towards a new type of partnership that would spring up once the reforms were instituted and that would run businesses that rival businesses run by publicly-traded corporations. It should be noted, however, that, unlike complete repeal of the UBIT, the reforms should not encourage a tax-exempt entity to shift investment away from publicly-traded corporations towards unrelated business ventures controlled by the tax-exempt entity. This is so because the proposed reforms, by adopting a test based on control, would still subject an investment in such a business to the UBIT.

As to the first two possibilities, these potential distortions are much less likely to arise than the current misallocation of resources from for-sale housing funds to rental property funds or the current misallocation of resources from some private equity funds to other private equity funds. This is so because, while for-sale housing funds and rental property funds are likely to be viewed by tax-exempt entities as close investment substitutes (and, likewise, one private equity fund is likely to be viewed as fairly interchangeable for another private equity fund), investment in any type of real estate fund or private equity fund is unlikely to be viewed as a close substitute for an investment in stock of a large, publicly-traded corporation.

The recent experience of tax-exempt entities encountering what has been referred to as the “denominator effect” when managing their investment portfolios demonstrates the extent to which tax-exempt entities do not view investment in real estate funds and private equity funds as substitutable for investment in corporate equity. Regarding this “denominator effect” experience, a manager of an investment portfolio held by an educational endowment (like Harvard’s), for example, generally must adhere to stringent guidelines specifying the percentage of the portfolio that must be represented by different classes of investments. During 2008, as the price of equity

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111 See supra notes 58 to 60 and accompanying text.
112 For similar reasons, Professor Slemrod has observed that, given that consumption of leisure is not taxed, economic efficiency might be furthered by taxing relatively lightly commodities that are substitutes for leisure (such as work uniforms) and taxing relatively heavily commodities that are compliments to leisure (such as skis). Joel Slemrod, Optimal Taxation and Optimal Tax Systems, 4 JOURNAL OF ECONOMIC PERSPECTIVES 157, 159 (1990). Likewise, in terms of tax that might be imposed on capital that is used as a factor of production, it has been observed that if some types of such capital are untaxed, capital that is a substitute for the untaxed capital should be taxed lightly in order to promote economic efficiency. See, e.g., Martin Feldstein, The Second Best Theory of Differential Capital Taxation, NBER Working Paper Series No. 1781. See also Alan D. Viard, Two Cheers for Corporate Tax Base Broadening, 62 NAT’L TAX J. 399 (2009).
113 For example, the “policy portfolio” that is used as a guideline for investment allocations made by Harvard’s endowment specifies that, in 2010, 11% should
shares in most corporations fell, the total size of an entity’s investment portfolio (or the denominator used for determining the fraction represented by each class of investment) shrunk. However, because certain investments (such as investments in real estate funds and private equity funds) are valued less frequently than investments in publicly-traded stock, at least on record the value of investments in real estate funds and private equity funds held relatively constant while the size of the total portfolio contracted. Consequently, tax-exempt entities found themselves holding investment portfolios in which investments in real estate funds and private equity funds represented a fraction greater than the fraction specified by their investment guidelines. Maintaining the proper portfolio balance was so important (or, in other words, substituting away from corporate equity and towards real estate funds and private equity funds was so undesirable) that tax-exempt entities began to sell their holdings in real estate funds and private equity funds. Indeed, they sold their interests in such funds even though they were forced to sell their interests in the funds at deep discounts, as a result of the economic climate and the fact that a liquid market for such interests does not exist.\textsuperscript{114} If anything, the experience of having to sell non-publicly traded equity at a deep discount, in part because of the lack of a liquid market, would make tax-exempt entities even less likely to substitute away from investment in publicly-traded corporations and toward investment in real estate funds and private equity funds in the future. Moreover, if tax-exempt entities were not even willing to hold a larger percentage in real estate funds and private equity funds than their targeted percentages when the larger percentage was artificially created by the fact that funds are priced less frequently than corporate equities, tax-exempt entities should be even less willing to substitute away from corporate equities and towards private equity funds and real estate funds in a non-artificial, economic manner.\textsuperscript{115}

\begin{itemize}
\item The reasons described above for why the potential new distortions may be less problematic than existing distortions do not support the conclusion that
\end{itemize}
As to the third possible new distortion, for reasons described below, it is unlikely that partnerships will ever run businesses that rival businesses owned and run by large corporations. Therefore, the risk that this new distortion would arise is remote.

b. Other Objectives of Imposing the UBIT on Non-Debt-Financed Income

As discussed above, the reforms proposed by this paper would better serve the goal of mitigating distortions that influence investment decisions made by tax-exempt entities. As described below, the proposed reforms would not subvert any of the other possible goals of imposing the UBIT on non-debt-financed income.

i. Avoiding Unfair Competition

1. Unfair Competition in the Form of Pricing Taxable Competitors Out of the Market

the potential new distortions would not arise at all. Such a claim would unwisely contradict the contention made by many scholars that the corporate tax system, by imposing a higher effective rate of tax on investment by taxable persons in corporations than on investment by taxable persons in partnerships, can cause a shift in investment away from corporations and toward partnerships. See, e.g., Karen C. Burke, Is the Corporate Tax System Broken?, 28 VA. TAX REV. 341, 345 (2008); Joseph M. Dodge, A Combined Mark-to-Market and Pass-through Corporate-Shareholder Integration Proposal, 50 TAX. L. REV. 265, 269 (1995); R. Glenn. Hubbard, Corporate Tax Integration: A View From the Treasury Department, 7 JOURNAL OF ECONOMIC PERSPECTIVES 115, 117 – 19 (1993); Charles E. McLure, Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, 88 HARV. L. REV. 532, 540 – 41 (1975); Anthony P. Polito, Advancing to Corporate Tax Integration: A Laissez-Faire Approach, 55 S.C. L. REV. 1, 15 - 17 (2003); Alvin Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 HARV. L. REV. 719, 725 (1981). Rather, the above arguments instead support the conclusion that the extent to which the proposed reforms would cause a shift in investment by tax-exempt entities from corporations to partnerships is somewhat limited. This conclusion is consistent with scholarship in the field of corporate tax integration. For example, Professor Rudnick has argued that, because taxable investors have a preference for liquidity, they will continue to invest in entities that are treated as corporations even though such investments may bear a higher effective rate of tax than a less liquid investment in an entity treated as a partnership for tax purposes. Rudnick, supra note 114, at 986, 1103 – 1106 (1988). See also Dodge, supra note 115, at 271.

116 See infra notes 128 to 144 and accompanying text.

117 Regarding an additional reason why all three of these possibilities may be less problematic than they might initially seem, see infra note 171.
Even granting that closer scrutiny reveals that the prevention of unfair competition objective is not as sound as it may first appear,\footnote{See supra notes 65 to 67 and accompanying text.} it is nevertheless worthwhile to consider whether the proposed reforms would further or hinder this objective, given that it played a prominent role in the legislative history. Moreover, as scholars who have criticized the unfair competition rationale for the UBIT have observed, while the likelihood of unfair competition absent the UBIT might have been remote or non-existent, adoption of the UBIT itself created the possibility of unfair competition.\footnote{In particular, if a tax-exempt entity is subject to the UBIT on the best alternative use of its funds, it might charge lower prices than an equally efficient taxable competitor in a UBIT-exempt business. See supra note 67 and accompanying text.} Consequently, it is appropriate to evaluate the impact of any prospective changes to the UBIT on the potential for unfair competition. Regarding the reforms proposed by this paper, the reforms are designed in a manner so that they will not impede the ability of the UBIT to prevent unfair competition (in the form of pricing taxable competitors out of the market), for the same reasons that exempting dividends from the UBIT does not weaken the ability of the tax to prevent unfair competition.

As described above,\footnote{See supra notes 68 to 70 and accompanying text.} Congress justified exempting certain passive types of income (including dividends) from the UBIT, in part, based on the belief that these types of income do not present a threat of unfair competition. While this belief has questionable validity in the context of certain other types of passive income,\footnote{See supra note 70.} a cogent argument could be made for exempting dividends on this basis. In particular, we would not expect a widely-held corporation owned by tax-exempt investors and taxable investors to engage in unfair competition.

For this purpose, if one corporation sets lower prices than prices charged by a competitor, the behavior only constitutes “unfair” competition if the lower prices result solely from the fact that the former corporation raises more equity than the its competitor from tax-exempt shareholders. If the price differential is attributable to any other factor, it is not “unfair” competition of the type that the UBIT could possibly correct. In order to determine whether a corporation (“Corporation A”) could potentially engage in “unfair” competition of this sort, one can imagine a hypothetical corporation (“Corporation B”) that is identical to Corporation A in all respects except that Corporation B is owned by all taxable shareholders and one can ask whether Corporation A would charge lower prices for its goods or services than
Corporation B. Imagining a corporation that is identical in all respects but for the tax status of its owners is used as a way to ensure that any price differential that could exist would, in fact, be attributable solely to the fact that Corporation A raises more equity from tax-exempt shareholders than Corporation B. Next, it is important to observe that all shareholders in Corporation A would share in returns pro rata based on capital invested. Therefore, if Corporation A is owned by tax-exempt shareholders and taxable shareholders, a pricing scheme that generates a 15% pre-tax return for its tax-exempt shareholders will also generate a 15% pre-tax return for its taxable shareholders. If, for sake of argument, one assumes that Corporation A does charge prices that are lower than prices charged by Corporation B, then Corporation B would generate a pre-tax return in excess of 15% for its shareholders, since Corporation A and Corporation B are identical corporations but for the identity of their owners. At this point, it can be shown that the facts that have been assumed are logically inconsistent because the facts would lead to a result in which taxable shareholders invest in Corporation A to earn a pre-tax return of 15% even though an investment in an identical corporation (Corporation B) would generate a higher pre-tax return. Stated another way, as long as Corporation A is owned by some taxable shareholders, pre-tax returns demanded by its taxable shareholders will prevent Corporation A from engaging in “unfair” competition of the type that the UBIT might possibly address.

Similarly, if income earned by tax-exempt entities from an investment in a partnership is no longer subject to the UBIT, as long as some taxable entities also invest in the partnership and share in returns pro rata based on capital invested, the partnership must not be engaging in unfair competition by setting prices lower than the prices that would be set by an otherwise identical partnership owned by solely taxable entities. By design, the new UBIT exemption proposed by this paper would only apply in such a case. In particular, as described above in Part IV, the new UBIT exemption only applies if taxable investors invest a non-trivial amount of capital in the partnership and share in economic returns of the partnership alongside tax-exempt investors pro rata based on the amount of capital invested.123

122 In order to evaluate whether any tax-exempt entity, individually, would unfairly compete with a taxable entity, Professor Knoll engages in a similar exercise. Knoll, supra note 64, at 866 - 67.
123 For this purpose, capital invested by a taxable investor might include capital invested by the sponsor of a hedge fund, real estate fund, or private equity fund since typically the sponsor of such a fund is taxable. However, the sponsor does not share with tax-exempt investors pro rata based on capital invested because the sponsor receives a carried interest. Therefore, as a precautionary measure, it might be wise to not allow capital invested by a sponsor to qualify the fund for the new exemption because carried interest could theoretically be used as a means of shifting a portion of the benefit of a tax-exempt partner’s tax-exempt status to the sponsor. This limitation would
2. “Unfair” Competition in the Form of Rapid Expansion

Regarding “unfair” competition in the form of rapid expansion, it is true that a partnership owned by predominately taxable investors may have to distribute more cash to its investors than a partnership owned by predominately tax-exempt investors. This would be the case if the partnership agrees to distribute sufficient cash to its investors in order to enable them to pay tax liability incurred as a result of income allocated to them by the partnership. Consequently, all else being equal, a partnership owned by predominately taxable investors could have less available cash to use to expand its business. However, as others have observed, a partnership owned by taxable partners could erode any resulting advantage possessed by a partnership owned by tax-exempt partners by borrowing funds or raising additional equity. Furthermore, it is not clear why we should be more concerned about the rapid expansion by a partnership that happens to be engaged in activities generating income that is subject to the UBIT (such as a real

only be a precautionary measure because using carried interest to shift the benefit of a tax-exempt partner’s tax-exempt status to the sponsor is, as a practical matter, unlikely for two reasons. First, such a benefit-shifting arrangement would be unlikely because it could jeopardize the tax-exempt status of the tax-exempt partner under the private benefit doctrine. For a discussion of the private benefit doctrine, see John D. Colombo, In Search of Private Benefit, 58 Fla. L. Rev. 1063 (2006). Second, if the partners in a real estate fund were inclined to engage in benefit-shifting behavior, even now there would be opportunity to do so with respect to income earned by real estate funds. In particular, rental income earned by a real estate fund is generally exempt from the UBIT under current law, as long as it is not debt-financed (and, with proper structuring, even if it is debt-financed). See supra notes 44 to 52 and accompanying text. Therefore, if they were inclined to do so, real estate fund sponsors and tax-exempt investors, even now, might take advantage of this exemption by charging lower rents with respect to rental property and using carried interest to shift a portion of the benefit to the sponsor. If parties were engaging in such behavior, however, we would not expect to see that (1) carried interest terms tend to be the same with respect to taxable investors as tax-exempt investors and (2) carried interest terms tend to be uniform across funds regardless of whether they invest in rental real estate or for-sale housing. However, we do in fact see both (1) and (2). Regarding the fact that we tend to observe (1), see LePree, supra note 37, at 843.

124 Indeed, for this reason, the Tax Court rejected a taxpayer’s argument that the prevention of unfair competition rationale does not apply in the case of a tax-exempt entity that invests as a limited partner (and, therefore, lacks control over pricing decisions made by the partnership). Service Bolt & Nut Profit Sharing Trust v. Comm’r, 78 T.C. 812 (1982), upheld by Service Bolt & Nut Profit Sharing Trust v. Comm’r, 724 F.2d 519 (6th Cir. 1983).

125 See supra note 64 and accompanying text.
estate fund that sells for-sale housing) than the rapid expansion by a partnership engaged in activities generating income exempt from the UBIT (such as a real estate fund that invests in rental properties).

ii. Preventing Erosion of the Corporate Tax Base

One might challenge the proposed reforms on the grounds that they would encourage erosion of the corporate tax base. In particular, whereas under current law tax-exempt entities collectively own large stakes in entities taxed as corporations, after enactment of the proposed reforms, entities treated as partnerships for tax purposes could begin to replace corporations as the vehicles through which tax-exempt entities would invest passively in active businesses. Consequently, the U.S. Treasury could forego a large portion of corporate tax revenue currently collected from corporations in which tax-exempt entities hold significant interests.

However, as a result of the publicly-traded partnership rules, the risk that such corporate tax base erosion would occur is remote. Regarding the publicly-traded partnership rules, the Internal Revenue Code provides that generally a “publicly-traded partnership” will be treated as a corporation for tax purposes. A “publicly-traded

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126 For statistics regarding corporate equity ownership by certain tax-exempt entities, see supra notes 30 and 31.
127 It is possible that the proposed reforms would result in some loss of corporate tax revenue because start-up businesses owned by private equity funds that are currently treated as corporations, for tax purposes, might be replaced by entities treated as pass-through entities for tax purposes if the reforms were adopted. For discussion of how the current tax treatment of tax-exempt entities may lead to private equity funds opting to treat entities in which they invest as corporations for tax purposes, see supra note 54 and accompanying text. However, to the extent that other factors influence the decision regarding whether or not to invest in entities treated as corporations for tax purposes, it is not clear that the reforms proposed by this paper would have an impact on the ultimate outcome.
128 I.R.C. § 7704(a). An exception is provided for publicly-traded partnerships that earn predominately certain types of passive income (such as interest, dividends, real property rents, and the like). I.R.C. §§ 7704(c) and 7704(d). This exception would not be applicable to a partnership engaged in an active business of the type generally run by entities treated as corporations for tax purposes. One concern about relying on the publicly-traded partnership rules to prevent erosion of the corporate tax base might be that the publicly-traded partnership rules could be undermined by tax structuring, along the lines of structuring used by Blackstone at the time of its initial public offering of interests in a partnership that was entitled to a share of carried interest and fees received by Blackstone as sponsor to a variety of funds. However, the structure used by Blackstone can only reduce corporate tax liability if some of the entity’s underlying income would be passive income absent structuring. If a publicly-traded entity earns 100% active business income from conducting a
partnership” means a partnership the interests in which are either (1) traded on an established securities market or (2) readily tradable on a secondary market (or the substantial equivalent thereof).129 Consequently, if the interests in a partnership were traded on the New York Stock Exchange or NASDAQ, for example, the partnership generally would be treated as a corporation for tax purposes.130

Furthermore, even if interests in a partnership are not traded on an exchange, if, given all the facts and circumstances, partners are readily able to buy, sell or exchange their partnership interests in a manner that is economically comparable to trading on an established securities market, the partnership will generally be treated as a corporation for tax purposes.131 Given that the determination of whether or not a partnership falls within this provision is uncertain and fact-specific, the Treasury Regulations provide certain safe harbors in order to give comfort to partnerships not intended to be captured by the publicly-traded partnership rules. While it is not required that a partnership fall within the safe harbors to be treated as a partnership for tax purposes, there is certainly a risk that an entity that does not fall within the safe harbors will be treated as a publicly-traded partnership, generally taxed as a corporation. The primary safe harbors are the private placement safe harbor and the lack of actual trading safe harbor. The private placement safe harbor applies to a partnership if interests in the partnership are issued in a transaction that is not required to be registered under the Securities Act of 1933 and the partnership does not have more than 100 partners at any time.132 The lack of actual trading safe harbor applies to a partnership if not more than two percent of the total interests in partnership capital or profits are transferred during any given year.133

Consequently, as a result of the publicly-traded partnership rules, generally a partnership earning active business income that is either traded on an exchange or that has more than 100 partners and is traded to any significant extent will be treated as a corporation for tax purposes.134 It is unlikely that, if the proposed reforms were enacted, active businesses currently run by corporations would be run, instead, by entities that could qualify for partnership tax treatment under these publicly-traded partnership rules.

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129 I.R.C. § 7704(b).
130 See Treas. Reg. § 1.7704-1(b).
131 See Treas. Reg. § 1.7704-1(c).
132 See Treas. Reg. § 1.7704-1(h).
133 See Treas. Reg. § 1.7704-1(j).
134 This is subject to the exception provided for publicly-traded partnerships that earn predominately certain passive types of income. See supra note 128.
For one thing, the differential tax treatment faced by taxable investors under current law when investing in an entity treated as a corporation for tax purposes versus an entity treated as a partnership for tax purposes should have been sufficient to motivate the replacement of corporations with partnerships if it were feasible to do so. Under current law, taxable persons that invest in an entity treated as a corporation for tax purposes indirectly bear their share of tax imposed on the corporation at an entity level and also are liable for tax on dividend income or gain from sale of shares in the corporation. On the other hand, taxable persons that invest in an entity treated as a partnership for tax purposes generally only bear one level of tax. Therefore, if it were feasible to do so, taxable investors would already have a strong tax incentive to organize businesses as partnerships rather than corporations for tax purposes. Indeed, fear that this incentive would lead to erosion of the corporate tax base was the primary reason why Congress enacted the publicly-traded partnership rules in the first place.

However, likely because of the publicly-traded partnership rules, taxable investors have not organized all businesses as partnerships rather than corporations for tax purposes. For the same

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135 This is true assuming that the economic burden of the corporate level tax is borne by shareholders, a plausible but not unavoidable assumption. See infra note 160.

136 For various reasons, the effective tax rate imposed on an investment by a taxable person in a corporation is likely not as much as twice the effective tax rate imposed on an investment by a taxable person in a partnership. For one thing, corporate tax preferences (such as favorable depreciation rules) can reduce corporate level tax. Also, corporate level tax can be reduced as a result of deductible interest payments made with respect to debt issued by a corporation. Furthermore, at the shareholder level, under current law, dividend income is generally taxed at a favorable 15% rate through 2010. Even in the absence of a favorable tax rate for dividends, shareholder level tax can be reduced if a corporation does not pay dividends and the shareholder, instead, recognizes economic gain by selling stock resulting in gain taxed at capital gain rates. However, the effective tax rate imposed on an investment by a taxable shareholder in a corporation may nonetheless be somewhat higher than the effective rate imposed on an investment by a taxable partner in a partnership. For discussion regarding estimating the effective tax rate borne by corporations, see, for example, George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 Va. L. Rev. 1793 (2003).

137 See H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065 (“To the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.”)

138 For similar discussion, see Polito, *supra* note 115, at 18 - 20.
reasons, if the proposed reforms were adopted so that tax-exempt investors benefited from more favorable tax treatment with respect to an investment in a partnership compared to an investment in a corporation, it is unlikely that entities treated as partnerships for tax purposes would replace entities currently treated as corporations for tax purposes.

The publicly-traded partnership rules effectively ensure that this is the case because generally the price for organizing a business as a partnership for tax purposes is foregoing widely dispersed equity ownership and liquidity for shareholders. Others have described persuasive explanations for why this non-tax cost likely outweighs any tax benefit in the case of businesses that are treated as corporations under current law.\footnote{Id. at 18 - 20; Rudnick, supra note 114, at 986, 1103 - 1106; Herwig J. Schlunk, I Come Not to Praise the Corporate Income Tax, But to Save It, 56 TAX. L. REV. 329, 356 – 57 (2003); Jeffrey K. Mackie-Mason & Roger H. Gordon, How Much Do Taxes Discourage Incorporation?, 52 JOURNAL OF FINANCE 477, 485 (1997); Jane G. Gravelle & Laurence J. Kotlikoff, The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good, 97 JOURNAL OF POLITICAL ECONOMY 749, 756 – 57 (1989).}

First, businesses currently treated as corporations for tax purposes tend to be businesses that benefit from economies of scale, so that large businesses have an advantage over small businesses.\footnote{See, e.g., Polito, supra note 115, at 18 - 20; Gravelle & Kotlikoff, supra note 139, at 756 – 57.} Second, there are various reasons why large businesses benefit from widely dispersed equity ownership and why widely dispersed equity owners of large businesses benefit from liquidity. Widely dispersed equity ownership is necessary to raise the amount of capital required by a large business, assuming that any given shareholder does not want to invest a large amount. Any given shareholder will not want to invest a large amount because any given shareholder will want to hold a diverse pool of investments and therefore will not want to invest a large amount in any given company.\footnote{See, e.g., Polito, supra note 115, at 18 - 20; Gravelle & Kotlikoff, supra note 139, at 756 – 57.} Further, widely dispersed equity owners of large businesses benefit from liquidity because, being unable to effectively monitor business decisions made by a large business in which they own a small stake, equity owners demand the security afforded by the ability to easily exit the business by selling their shares.\footnote{See, e.g., Polito, supra note 115, at 18 - 20; Rudnick, supra note 114, at 986, 1121 - 22; Mackie-Mason & Gordon, supra note 139, at 485; Gravelle & Kotlikoff, supra note 139, at 756 – 57.} In addition, as described in more detail above,\footnote{See supra note 114 and accompanying text.} liquidity helps equity holders maintain a diverse portfolio. This is the case because being able to easily sell shares in any given corporation will help equity holders
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rebalance their portfolio if share prices change so that shares in one corporation represent an undesirably large portion of the equity holder’s overall portfolio.\footnote{144}

iii. Preventing Managerial Diversion

Limiting the new UBIT exemption to situations in which a tax-exempt entity lacks control over ordinary business decisions made by a partnership ensures that the new exemption only applies to investments that demand limited time and energy from a tax-exempt entity’s managers. Therefore, the proposed new UBIT exemption should not undermine the ability of the UBIT to discourage managerial diversion, since it only applies in situations in which the tax-exempt entity lacks control over ordinary business decisions made by the partnership.\footnote{145}

iv. Encouraging Liability Insulation

While preventing the exposure of charitable assets to the risks of non-charitable enterprises might be a reason to discourage tax-exempt entities from acting as general partners of commercial partnerships, if a tax-exempt entity invests as a limited partner in a limited partnership or as a non-managing member in a limited liability company, the tax-exempt entity’s liability will be limited to the amount invested. Therefore, the proposed reforms, because they apply only to investments made in such a capacity, should not interfere with any liability insulation objective motivating the UBIT.

v. Preventing Over-Subsidization of Tax-Exempt Entities

\footnote{144} Real estate funds, private equity funds, and hedge funds, on the other hand, can be organized as partnerships for at least two reasons. First, most real estate funds and private equity funds have a specified limited term. In other words, after a specified number of years, the fund will be required to sell any remaining assets and distribute proceeds to its investors. Consequently, these self-liquidating investments provide liquidity even though equity owners are not able to readily buy and sell interests in the funds. Second, in the case of hedge funds, the underlying investments tend to be fairly liquid and investors typically have some right to require the fund to redeem their interests based on the current value of underlying assets. Therefore, hedge funds also provide a measure of liquidity even if there is not a market in which investors can readily sell their interests. Moreover, because most of the underlying income of a hedge fund is passive income, a hedge fund can generally qualify for the exception from treatment as a corporation for publicly-traded partnerships that earn predominately certain types of passive income. See supra note 128. Therefore, even if there is a liquid market for redeeming interests in a hedge fund, the hedge fund could likely be treated as a partnership for tax purposes. \footnote{145} See supra Part IV.
If the extent of the subsidy granted to a tax-exempt entity is measured as the difference between the amount of income the tax-exempt entity earns and the amount of income the tax-exempt entity would earn if it were taxed in the same manner as a taxable entity, then the proposed reforms could certainly increase the amount of the subsidy granted to a tax-exempt entity. For example, assume that a tax-exempt entity is considering two possible investments. Possibility one is a limited partner interest in a real estate fund that invests in rental properties giving rise to income not subject to the UBIT and generating a 15% pre-tax return. Possibility two is a limited partner interest in an otherwise comparable real estate fund that invests in for-sale housing giving rise to income that is subject to the UBIT and generating a 20% pre-tax return. Absent the proposed reforms, the tax-exempt entity would choose possibility one, since possibility one produces an after-tax return of 15% while possibility two produces an after-tax return of only 13%. Furthermore, the subsidy would be the difference between a 15% after-tax return and the 13% after-tax return that would be earned if the tax-exempt entity was treated as a taxable entity (in which case, both investments would be subject to 35% tax and the tax-exempt entity would choose possibility two). If the proposed reforms were enacted, the tax-exempt entity would be subject to tax on neither investment and would choose possibility two. The resulting subsidy would now be the difference between a 20% after-tax return and the 13% after-tax return that would be earned if the tax-exempt entity was taxed at 35% on both investments.\textsuperscript{146}

Nevertheless, there are a number of reasons to not reject the proposed reforms on the grounds that they could increase the subsidy granted to tax-exempt entities. First, because of the considerations discussed above,\textsuperscript{147} there is no basis to believe that the amount of subsidy granted under the current state of the law is precisely the right amount of subsidy. Second, while the proposed reforms have the

\textsuperscript{146} The proposed reforms could also increase the amount of the subsidy granted to a tax-exempt entity in situations in which the tax-exempt entity would choose to invest in the for-sale housing fund even absent the proposed reforms. Assume in the example above that the facts were the same except the for-sale housing fund generates a pre-tax return of 25% instead of 20%. Under these facts, the tax-exempt entity invests in the for-sale housing fund regardless of whether or not the proposed reforms are adopted. Absent the proposed reforms, no subsidy would exist because the 16.25% after-tax return earned by the tax-exempt entity is the same return the tax-exempt entity would earn if both investments were subject to 35% tax. If the proposed reforms were adopted, the subsidy would be the difference between a 25% after-tax return earned from a tax-free investment in the for-sale housing fund and a 16.25% after-tax return that would be earned if both investments were taxed at 35%.

\textsuperscript{147} \textit{See supra} notes 77 to 79 and accompanying text.
potential to result in tax-exempt entities earning a greater amount of excess income (where excess income is the amount by which income earned exceeds income that would be earned if tax-exempt entities were treated like taxable entities), the reforms do so, in part, by potentially encouraging tax-exempt entities to invest in assets that generate a higher pre-tax return. Continuing to discourage tax-exempt entities from investing in assets that lead to higher pre-tax returns as a means of curtailing the amount of their subsidy creates distortions and is arguably undesirable, particularly when there is no convincing reason to believe that the increased subsidy ought to be avoided. An increased subsidy is arguably even less of a concern with respect to pension plans than other tax-exempt investors, since income earned by pension plans will, eventually, be subject to tax when it is distributed to the beneficiaries of the pension plan and since accumulating investment income is a pension plan’s purpose.\textsuperscript{148} Even in the context of other tax-exempt investors, however, if the increased subsidy resulting from the proposed reforms is a concern, rather than limiting the subsidy by taxing certain types of investment income but not other types of investment income, it would be preferable (from the standpoint of mitigating distortions) to limit the subsidy by taxing all investment income at the same rate.\textsuperscript{149}

\textbf{vi. Subjecting All Income Unrelated to an Entity’s Tax-Exempt Purpose to at Least One Level of Tax}

Implementing the proposed reforms would lead to a tax system that diverges from a system that subjects unrelated income earned by a tax-exempt entity to at least one level of tax. In particular, under the proposed reforms, a tax-exempt entity could passively invest in a partnership and earn income that was neither subject to tax at the partnership level nor subject to tax in the hands of the tax-exempt entity. However, current tax law also falls short of fully achieving the objective of taxing all unrelated income earned by a tax-exempt entity at least once. For example, the fact that the tax law explicitly exempts rental income received from real estate, interest income, and royalty income from the scope of the UBIT is inconsistent with the goal of

\textsuperscript{148} Indeed, because of the special considerations that apply to pension plans, the exemption from the debt-financed income rules provided for debt-financed income earned from real estate was, initially, limited to pension plans. See, \textit{e.g.}, McDowell, \textit{supra} note 74, at 715 (“Further, the Treasury concluded that an exception limited to pension funds could be justified on the ground that the exemption for investment income was the \textit{raison d’etre} of the exemption granted to pension funds; whereas the exemption for investment income was a mere ‘by-product’ of exemptions granted to other organizations.”)

\textsuperscript{149} However, for reasons discussed below, not necessarily at 35% if some amount of subsidy is desirable. \textit{See infra} notes 166 to 167 and accompanying text.
taxing all unrelated income at least once.\textsuperscript{150} If the desired result is, indeed, to subject all unrelated income earned by tax-exempt entities to at least one level of tax, then steps should be taken to close the considerable gap between that goal and the current state of the law. Such reform would be along the lines of the alternative set of reforms discussed below,\textsuperscript{151} and, for the reasons discussed below, such reform is likely unfeasible and even undesirable.

In addition, it is not clear that the goal of taxing all unrelated income earned by tax-exempt entities at least once should be pursued. There are three ultimate objectives that conceivably might be furthered by taxing all such income at least once. First, taxing all such income at least once might reduce distortions. However, as discussed elsewhere,\textsuperscript{152} absent reform that subjects all investment income earned by tax-exempt entities to the same effective tax rate (which would represent a drastic departure from current law), the proposed reforms serve the goal of mitigating distortions better than the current tax system. Second, taxing all such income at least once might prevent erosion of the corporate tax base. However, as discussed above,\textsuperscript{153} the proposed reforms are unlikely to lead to erosion of the corporate tax base. Finally, taxing all such income at least once might prevent over-subsidization of tax-exempt entities. However, for the reasons discussed above,\textsuperscript{154} preventing over-subsidization is not a convincing objection to enactment of the proposed reforms.

c. Objectives of the Debt-Financed Income Rules

The reforms proposed by this paper would not subvert either of the possible goals of the debt-financed income rules.

i. Preventing Over-Subsidization of Tax-Exempt Entities

If the proposed reforms were enacted, the subsidy provided to tax-exempt entities would increase because they could invest passively

\textsuperscript{150} Also, tax-exempt entities can invest in REITs in ways that allow them to escape tax altogether. Professor Schwarz points to the pension-held REIT rules as supportive of his observation that the tax law seeks to impose at least one level of tax on all income earned by a tax-exempt entity not related to its tax-exempt purpose. \textit{Schwarz}, supra note 70, at 56 – 57. However, as discussed above, tax-exempt entities frequently invest through REITs in situations in which the pension-held REIT rules do not apply. \textit{See supra} notes 51 to 52 and accompanying text.

\textsuperscript{151} \textit{See infra} notes 165 to 171 and accompanying text.

\textsuperscript{152} \textit{See supra} notes 103 to 117 and accompanying text and \textit{see infra} notes 158 to 171 and accompanying text.

\textsuperscript{153} \textit{See supra} notes 128 to 144 and accompanying text.

\textsuperscript{154} \textit{See supra} notes 147 to 149 and accompanying text.
in partnerships that use leverage without incurring liability for the UBIT under the debt-financed income rules. However, as discussed above, preventing over-subsidization of tax-exempt entities is an unconvincing rationale for the debt-financed income rules. Therefore, preventing over-subsidization of tax-exempt entities is an unconvincing objection to adopting the reforms proposed by this paper.

ii. Preventing Certain Sale-Leaseback Transactions

If the proposed reforms were enacted, tax-exempt entities would generally no longer be subject to tax as a result of passive investment in a partnership that borrowed funds. Therefore, the scope of the debt-financed income rules would effectively be narrowed. However, as discussed above, the debt-financed income rules are broader than necessary to combat the sale-leaseback transactions at which they were aimed. Therefore, reform that results in the debt-financed income rules generally no longer applying when a tax-exempt entity passively invests in a partnership that borrows funds should not hinder the ability of the tax law to discourage sale-leaseback transactions viewed as abusive because more narrowly tailored provisions can effectively deter the transactions.

d. Alternative Reforms

By evaluating the proposed reforms based on whether or not they would further the goals of the current system’s imposition of tax on tax-exempt entities, it can be seen that the proposed reforms would better serve the goal of mitigating distortions without subverting any of the other goals of taxing income earned by tax-exempt entities in the first place. Nevertheless, one could argue that other conceivable reforms could even more effectively mitigate distortions. As explained below, however, these alternative reforms are unfeasible or even undesirable. Therefore, the proposed reforms offer the best practical solution for improving the current state of the law.

i. Alternative One: Proposed Reforms Plus Corporate Tax Integration

As discussed above, non-tax considerations, such as the aim of maintaining a diversified investment portfolio, would likely result in tax-exempt entities continuing to invest a significant amount of capital

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155 See supra notes 84 to 86 and accompanying text.
156 See supra notes 89 to 90 and accompanying text.
157 Indeed already existing provisions may be adequate to deter the perceived abuse by limiting the benefits that taxable parties can gain from the transactions. See I.R.C. § 470.
158 See supra notes 112 to 115 and accompanying text.
in large, publicly-traded corporations even if the tax treatment of relatively illiquid investments in real estate funds and private equity funds became more beneficial than the tax treatment of investments in large, publicly-traded corporations. Nevertheless, also as discussed above, it is likely that tax considerations could play some role when a tax-exempt entity is deciding between an investment in a large publicly-traded entity treated as a corporation for tax purposes and an investment in a real estate fund or private equity fund. Under the proposed reforms, the tax-exempt entity would no longer be subject to tax on income earned from a typical real estate fund or private equity fund. However, assuming that the entity-level tax paid by entities treated as corporations for tax purposes is indirectly borne by shareholders, the tax-exempt entity would continue to indirectly bear the burden of entity-level tax in the case of an investment in an entity treated as a corporation for tax purposes. Moreover, if the more favorable tax treatment does, in fact, persuade a tax-exempt entity to invest in a real estate fund or private equity fund rather than a corporation, the tax-exempt entity may be choosing an investment that generates a lower pre-tax return over an otherwise comparable investment that would have generated a higher pre-tax return.

If tax considerations would influence tax-exempt entities to substitute investment in real estate funds and private equity funds for investment in large, publicly-traded entities treated as corporations for tax purposes, from the perspective of mitigating distortions, it may be preferable to adopt the proposed reforms and, in addition, modify the corporate tax system in a way that results in tax-exempt entities not bearing tax on investments in large, publicly-traded corporations. However, this more drastic reform is likely unfeasible for a number of reasons.

First, legal scholars, economists and others have long advocated for reform to the corporate tax system that would integrate the entity-level tax and the tax that applies to shareholders (other than tax-exempt shareholders) upon receipt of dividends. The end result of such integration would be a tax system that only applies one level of tax with respect to investment in a corporation by taxable shareholders.

159 See supra note 115.
160 This conclusion is plausible but not entirely unavoidable. A discussion of the economic incidence of the corporate income tax is beyond the scope of this paper. For discussion of the economic incidence of the corporate tax, see, for example, Harberger, supra note 106; Gravelle & Kotlikoff, supra note 139; Yariv Brauner, The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy, 2008 MICH. ST. L. REV. 591, 630 – 32 (2008); McLure, supra note 115, at 541 – 45. McLure, supra note 115; Warren, supra note 115.
161 A discussion of the arguments supporting corporate tax integration is beyond the scope of this paper. For some discussion of corporate tax integration, see, for example, Dodge, supra note 115; Hubbard, supra note 115; McLure, supra note 115; Warren, supra note 115.
However, despite abundant calls for corporate tax integration, corporations continue to bear entity level tax, and taxable shareholders continue to bear tax on dividends (although, since 2003 the tax rate on dividends has been reduced and will remain reduced through 2010, absent further legislative action).162

Second, even though many agree that corporate tax integration is a desirable goal, there is no consensus about exactly how corporate tax integration should be implemented. Many proposals have involved modifications to the taxation of dividends, without significant changes to tax imposed on corporations at the entity level.163 These proposals would not alter the effective tax rate borne by tax-exempt shareholders that are already generally exempt from tax on dividend income. Thus, even if corporate tax integration is accomplished, it is far from clear that it would be feasible to implement corporate tax integration in a manner that would result in tax-exempt shareholders bearing no tax with respect to an investment in a corporation, particularly given the amount of tax revenue that would be foregone.164

ii. Alternative Two: Truly Tax All Investment Income Once and Equally

Instead of eliminating tax imposed on tax-exempt entities with respect to passive investment in partnerships, the taxation of tax-exempt entities with respect to investment income could be modified in a very different manner. In particular, the tax system could be changed so that tax-exempt entities are taxed on investment income and are subject to exactly the same effective, non-zero rate of tax on all investment income. As is true in the case of the first alternative proposal, this alternative proposal could more effectively mitigate distortions than the proposed reforms if a tax-exempt entity is influenced by tax considerations when deciding whether to invest passively in an entity treated as a partnership for tax purposes (such as a real estate fund or private equity fund) or instead invest passively in

162 The reduced tax rate applicable to dividends is a modified form of a corporate tax integration proposal made by the Bush administration that would have provided for an exclusion at the shareholder level for dividends paid from income previously taxed at the corporate level. US Dept of the Treasury General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals 11-22 (2003).
163 For example, the Bush administration proposal described above would have moved towards integration by modifying the taxation of dividends. See supra note 162.
164 For statistics regarding corporate equity ownership by certain tax-exempt entities, see supra notes 30 and 31. Scholars have noted that one difficult question any corporate tax integration plan would need to address is whether integration should be accomplished in such a way that tax-exempt shareholders bear no tax. See, e.g., Hubbard, supra note 115, at 121; McLure, supra note 115, at 576.
an entity treated as a corporation for tax purposes (such as a large, publicly-traded entity). However, for a number of reasons, this alternative is likely unfeasible or even undesirable.

First, subjecting all investment income earned by tax-exempt entities to tax is likely unfeasible, and even undesirable, because taxing 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. The purpose of granting an exemption to pension plans, for example, is to encourage savings, in part by allowing investment income to accumulate tax free.\(^\text{165}\) Subjecting investment income of pension plans to tax would significantly obstruct this goal and would be met with tremendous political opposition.

Even for tax-exempt entities other than pension plans, taxing investment income could significantly lessen the extent to which their tax status grants them any special tax treatment.\(^\text{166}\) Therefore, if special tax treatment for tax-exempt entities is a desirable goal, exempting some income earned by the entities that is not directly related to their exempt purpose may be necessary.\(^\text{167}\) Furthermore, investment income may be the best candidate for such exemption given other concerns that apply to active business income (such as avoiding managerial diversion, as discussed above). Something along these lines may have been what Congress had in mind when, while discussing the decision to exempt various types of investment income from the UBIT, it stated that such income had “long been recognized as a proper source of revenue for educational and charitable organizations and trusts.”\(^\text{168}\)

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\(^{165}\) See supra note 148.

\(^{166}\) For one thing, as Professor Hall and Professor Colombo have observed, if income exempt from the UBIT is too limited, there would be “some question whether the income tax exemption provides a subsidy at all, given that gifts would not count as income even absent the exemption.” Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1386 (1991). See also Aprill, supra note 80, at 1110 (“Carried to its logical extreme, a rationale of taxing all income at least once would tax all interest, rent, royalties, annuities and other types of passive income earned by exempt organizations, not just payments made by controlled subsidiaries. To tax all income of tax-exempt organizations at least once might also call into question the charitable contribution deduction. If all income were taxed at least once, would there remain any meaningful exemption?”).

\(^{167}\) Indeed, some have argued that exempting some income of tax-exempt entities that is not directly related to their exempt purpose may be desirable. See, e.g., McDowell, supra note 74, at 725 (“The passive income exception also assists charitable organizations in gaining some degree of independence, and gives them the ability to weather unforeseen events in lean economic times.”)

\(^{168}\) See S Rep No 2375, 81st Cong, 2d Sess at 30-31 (1950).
Second, one important thing to note about this alternative is that it would not simply involve providing for the UBIT to apply to currently exempt investment income, such as rent, interest, royalties, and other types of investment income earned from assets not related to the tax-exempt entity’s exempt purpose. Rather, if the goal is to subject tax-exempt entities to exactly the same effective rate of tax on all types of investment income, some changes to the corporate tax system would also be required. Because of existing corporate tax preferences and other factors, corporations often pay tax at effective rates lower than the stated tax rate. Therefore, if, for example, rental income earned by tax-exempt entities were simply subject to 35% tax while dividend income received by tax-exempt entities were untaxed, because corporations may bear tax at effective rates lower than 35%, the effective tax rate on an investment in the corporation could be lower than the effective tax rate on rental income. If rental income and dividend income are both subject to the UBIT, then the effective tax rate on investment income earned from the corporation may be higher than the effective tax rate imposed on rental income. Equalizing the two effective tax rates would require integrating the corporate tax system and taking steps to eliminate corporate tax preferences. Consequently, the goal of imposing the same effective rate of tax on all investment income earned by tax-exempt entities may be unattainable because the necessary accompanying corporate tax reform may not be politically feasible.

VI. Conclusion

This paper proposes modest reform to the tax treatment of income earned by tax-exempt entities. In particular, given that the tax system generally does not tax investment income earned by tax-exempt entities, this paper takes the position that all income earned by a tax-exempt entity investing passively in a partnership should not be taxed. This is so because, if the tax-exempt entity is investing passively, then all

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169 For example, corporations can benefit from accelerated depreciation. In addition, when corporations issue debt, deductible interest payments reduce the amount of entity-level tax liability.

170 See, e.g., Polito, supra note 115, at 36–37; Viard, supra note 112, at 399.

171 Indeed, regarding the concern (described in notes 110 to 115 and accompanying text) that the proposal to exempt from the UBIT income earned from passive investment in a partnership could bias tax-exempt entities away from investing in corporations and towards investing in partnerships, in addition to the factors described above that mitigate this concern, one other point to keep in mind is that, under current law, it is possible that the tax imposed on some income earned from partnerships biases tax-exempt entities away from investing in partnership and towards investing in corporations. This could be so because the corporations may bear an effective rate of tax at the entity level that is less than the UBIT rate (as a result of corporate tax preferences) and dividends are not subject to the UBIT.
income earned by the tax-exempt entity ought to be viewed as investment income under a definition of investment income that accurately reflects the reasons for generally not taxing investment income. The fact that the existing rules regarding taxation of tax-exempt entities do not already provide for this result was an excusable oversight when the rules were adopted because passive investment by tax-exempt entities in partnerships was not prevalent at that time. However, given the rise of hedge funds, real estate funds, and private equity funds as vehicles through which tax-exempt entities invest, this inadequacy of the current rules is no longer acceptable. Moreover, modernizing the rules offers an important benefit. In particular, absent more fundamental changes to the tax system as a whole along the lines of alternative reforms discussed above, the reforms proposed by this paper would better serve the goal of mitigating distortions that influence investment decisions made by tax-exempt entities without subverting any of the other goals of taxing income earned by tax-exempt entities in the first place.