PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on September 6, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION AND SUMMARY

The Committee on Ways and Means of the House of Representatives has scheduled a public hearing on September 6, 2007, on the Federal tax issues in connection with partnership carried interests and related issues. This document,[1] prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis of Federal tax issues relating to partnership carried interests and related issues particularly involving the use of offshore entities.

Part One of this document provides background information about offshore structures for private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities. Part One also provides background information about tax-exempt investors and unrelated business income tax, foreign individual investors and income effectively connected to a trade or business, and deferral of income of managers. Part Two describes geographic distribution of hedge funds and private equity funds. Part Three describes present law and history of the law relating to unrelated business income tax and debt-financed income, an overview of U.S. international tax rules, and an overview of ways to defer services income under present law. Part Four provides a discussion of issues and analysis of Federal tax issues relating to these areas.

A companion document[2] relating to the Ways and Means Committee hearing on September 6, 2007, prepared by the staff of the Joint Committee on Taxation, provides a description of present law and analysis of Federal tax issues relating to partnership carried interests in general.

Part One of the companion document provides background information about carried interests and going-public transactions of partnerships involved in private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities. Part Two provides economic data relating to partnerships, and to private equity, venture capital, and hedge funds, and certain carried interests. Part Three describes present law relating to Federal tax rates for individuals, tax treatment of partnership profits interests for services, and tax rules relating to compensation and employment tax. Part Four describes present law relating to taxation of partners and partnerships, including publicly traded partnerships, and compares the tax treatment of taxable corporations and of passthrough and untaxed entities. Part Five describes recent legislative proposals. Part Six provides a description and analysis of Federal tax issues relating to carried interests.

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[1] This document may be cited as follows: Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II*", (JCX-63-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

[2] That document may be cited as follows: Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I*", (JCX-62-07), September 4, 2007. The document is available on the internet at www.house.gov/jct.

I. BACKGROUND

In general

Over the past several decades, private equity funds, venture capital funds, hedge funds, and similar alternative investment vehicles[3] have attracted large amounts of capital investment from institutional investors such as pension funds and educational and charitable institution endowments, as well as from wealthy individual investors. These investors become limited partners in the funds, which are generally structured as partnerships. Some of the funds are established in offshore jurisdictions.[4] The assets invested in the funds generally are managed by groups of individuals who contribute a relatively small amount of capital to the fund (in relation to amounts of capital contributed by the investors) and who provide investment expertise in selecting, managing, and disposing of fund assets.

Investors in the funds have historically (though not exclusively) been of three general types: high net-worth individuals who are subject to U.S. tax; foreign persons who are not otherwise subject to U.S. tax; and U.S. institutional investors (such as charities and private and government pension funds) that are tax-exempt under U.S. tax rules.[5] These types of investors have differing U.S. tax situations, and therefore, have differing tax issues arising from investing in investment funds such as hedge funds and private equity funds. In general, high net-worth individuals may be concerned about limitations on deductions, such as the 2-percent floor on miscellaneous itemized deductions, the overall limitation on itemized deductions, and the alternative minimum tax. They may prefer to let the fund manager's carried interest serve to reduce their distributive share of partnership income as it is earned, rather than having a higher share of partnership income along with a deduction for manager compensation that may not be fully or currently usable because of a deduction limitation. Tax-exempt organizations and foreign persons not subject to U.S. tax may be even more indifferent to deductions. Instead, tax-exempt organizations may be concerned about becoming subject to unrelated business income tax. Foreign individuals may be concerned about becoming subject to U.S. tax and about U.S. withholding tax and the possibility of being required to file a U.S. income tax return (even if no tax is ultimately due).

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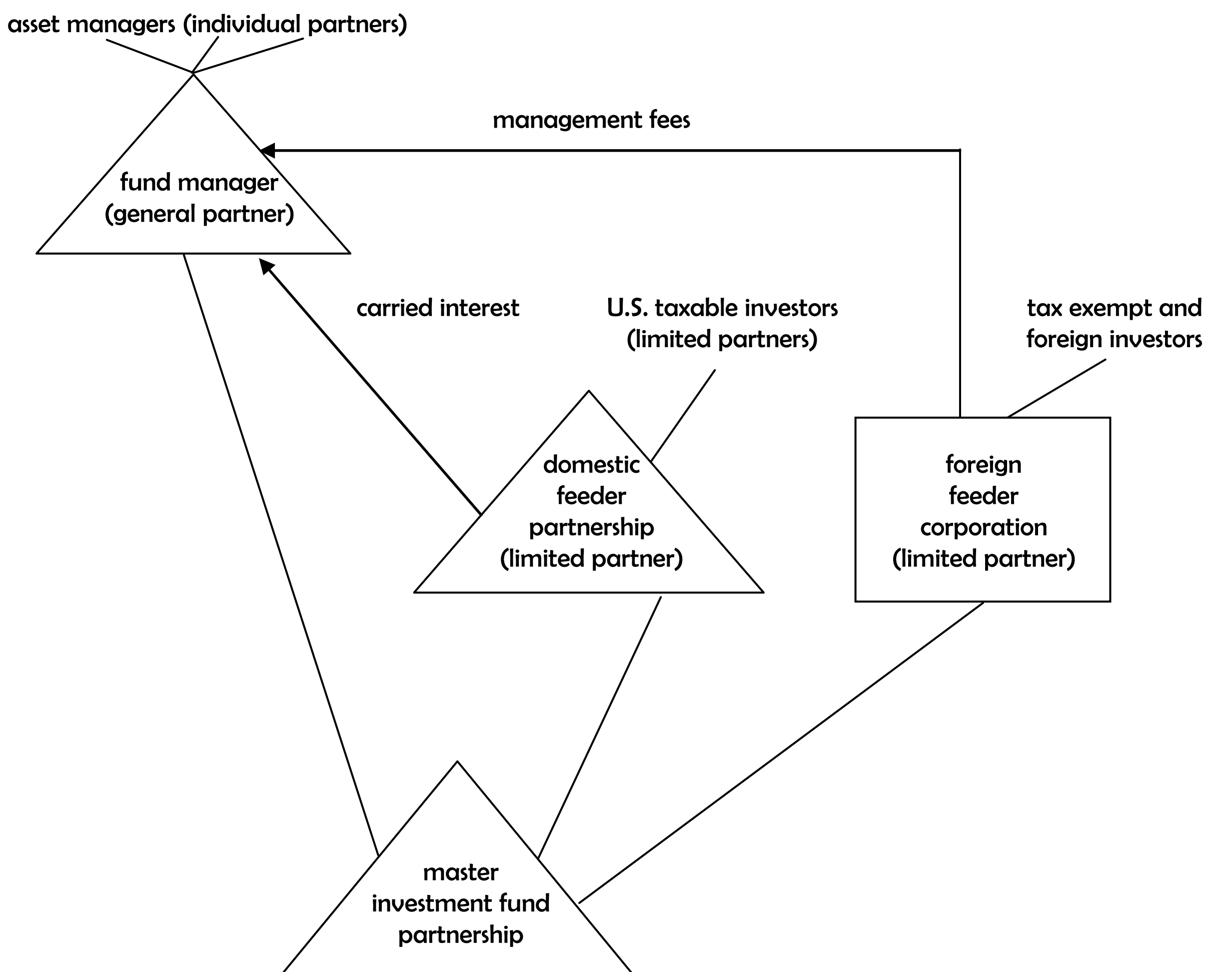
[3] These types of funds have differing investment strategies. These are briefly described in the Economic Data section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

[4] Lynnley Browning, "A Hamptons for Hedge Funds: Offshore Tax Breaks Lure Money Managers," *New York Times*, July 1, 2007.

[5] There are also other types of investors, including corporations subject to U.S. tax, and funds of funds. See the Economic Data section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

Funds have been structured to accommodate these various concerns. In addition, the structures may serve to maximize aggregate tax savings with respect to all the parties (investors and fund managers). These arrangements may be based on the "master-feeder" structure in which a single fund is held by separate domestic and foreign entities through which different types of investors invest.[6] The structure may include the interposition of a payor foreign corporation between the investment fund and certain of its investors, typically the fund's foreign and tax-exempt investors, which serves to block types of income received that could be subject to U.S. tax in their hands, and to convert this income to dividends (or interest) when distributed to them. The foreign corporation may also serve as an income deferral mechanism for individual fund managers in the case of management fees.

Investment Fund Structure with Foreign Feeder Corporation



[6] A variant involves the use of parallel U.S. and foreign funds with substantially similar investments. The master-feeder structure is described in the Background section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

Offshore entities

In general

An initial question involves what aspects of the structure and business activities of hedge funds and private equity funds and their managers are offshore. The inquiry involves whether (1) the investment fund itself is established in a foreign jurisdiction rather than in the U.S., (2) the assets of the investment fund are foreign or U.S. assets, (3) the individuals who are engaged in managing the investment fund reside outside the U.S., work outside the U.S., or conduct management activities through an entity established outside the U.S., and (4) intermediate entities through which investors (typically tax-exempt and foreign) invest in the fund are established in an offshore jurisdiction or in the U.S. Use of intermediate foreign corporations is relatively common, and sometimes the investment fund itself is established offshore.[7]

Interests in investment funds may be held through offshore corporations established in low-tax or zero-tax foreign jurisdictions for a variety of U.S. tax reasons. In general, a foreign corporation in such a jurisdiction may be viewed as preferable to a U.S. corporation because it is subject to little or no corporate income tax, whereas a U.S. corporation generally is subject to U.S. corporate-level income tax.

Tax-exempt investors and unrelated business income tax

One reason for investing in alternative asset funds through a foreign corporation relates to the imposition of unrelated business income tax ("UBIT") on tax-exempt organizations under present law. The assets of alternative asset funds often are ones that, if owned directly by a tax-exempt organization, would produce income that is subject to UBIT, because, for example, the assets are active business assets that are unrelated to the organization's exempt purpose, or the assets are debt-financed.

If tax-exempt organizations hold such investments through a partnership, a lookthrough rule applies, potentially subjecting the tax-exempt investors' returns to UBIT. By contrast, if tax-exempt organizations hold potentially UBIT-producing investments through a corporation, the corporation's separate existence generally is respected for Federal tax purposes so that the lookthrough rule does not apply, and dividends paid by the corporation to the tax-exempt investors generally are excluded from the investors' unrelated business taxable income. Tax-exempt organizations thus may have an incentive to invest in alternative asset funds through corporate entities, sometimes referred to as "UBIT blockers" or "blocker corporations." Such corporations may be established offshore in low-tax or zero-tax jurisdictions to avoid corporate tax at the blocker corporation level.

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[7] In some cases, the offshore investment fund is one of two parallel investment funds, the other of which is established in the United States.

Foreign individual investors and income effectively connected with a U.S. trade or business

In addition, foreign individuals may find it attractive to invest in an alternative asset fund through an offshore corporation rather than directly because by doing so, the individuals may avoid the direct imposition of U.S. tax on income effectively connected with a U.S. trade or business and the related requirement to file a U.S. tax return. Foreign individuals may also hold the view that it is preferable to invest through a foreign corporation in order to interpose an additional non-U.S. entity between themselves and U.S. taxing jurisdiction.

To the extent, however, that a foreign individual would have effectively connected income if the individual invested in a fund directly rather than through an offshore corporation, the foreign corporation itself has effectively connected income. Investment in a fund through an offshore corporation therefore generally does not reduce the aggregate U.S. tax liability of foreign individual investors. Some of the business activities of alternative asset funds may give rise to taxable U.S. effectively connected income for foreign individual investors or offshore feeder corporations. However, these funds generally rely on the trading safe harbors of section 864(b) to avoid U.S. trade or business status and resulting effectively connected income. In this connection, it has been questioned whether the section 864(b) trading safe harbors do or, as a policy matter, should protect foreign investors from having a U.S. trade or business that is subject to U.S. taxation in the context of these types of investment funds.

The United States generally taxes the worldwide income of its residents, and anti-deferral rules generally restrict the ability to defer U.S. taxation by deriving income through foreign corporations. Thus, U.S. resident individuals generally do not have a U.S. tax reason for relocating abroad to manage alternative asset funds. Similarly, U.S. resident individuals generally have no U.S. tax incentive to invest in alternative asset funds through foreign corporations.

Deferral of income of managers

The desire of certain investors to make their investments through an offshore corporation presents fund managers with a tax deferral opportunity that is generally not available through a U.S. corporation or partnership.[8] A foreign corporation provides the fund managers a structure that is conducive to deferring tax on compensation. The tax deferral opportunity is possible only if the fund manager structures its carried interest as a contractual right to compensation as opposed to a profits interest in the investment fund. Provided that present-law U.S. tax rules relating to nonqualified deferred compensation are satisfied, current income taxation on the fund manager's compensation and amounts earned on such deferred compensation can be postponed. In the case of an onshore investor who is subject to U.S. tax, structuring the carried interest as deferred compensation is not desirable as a tax planning matter because the payor's deduction is postponed under U.S. tax law until the amount is included in income by the fund manager. In

[8] For a discussion of the typical compensation structures of hedge funds, see David A. Sussman and Daniel A. Kalosieh, "Hedge Funds, Deferrals, and Taxes," *Investment Advisor*, November 2003 (article was published before the enactment of section 409A).

the case of a U.S. taxpayer, this deferral of the deduction creates a tension which, in theory, may limit the amount of compensation that is deferred. This tension is not present in the case of fund managers in offshore arrangements, either because funds are established in offshore jurisdictions and do not pay a corporate-level tax in the United States, or because investors are tax exempt or otherwise not subject to U.S. tax and are indifferent as to the timing of a tax deduction for compensation.

If the carried interest is structured as nonqualified deferred compensation, all amounts received by the fund manager pursuant to the carried interest are taxable as ordinary income. In contrast, if the carried interest is structured as a partnership profits interest in the fund, the fund manager's distributive share of the fund's income and loss items retains the character that those items had at the fund level under present law. Thus, to the extent the fund's income constitutes long-term capital gain or qualifying dividends eligible for the preferential capital gain tax rate, the consensus understanding of current law is that the fund manager's share of that income is eligible for the preferential capital gain tax rate. However, in the case of funds (such as hedge funds) whose investment strategy involves relatively rapid turnover of assets, income generated by the fund is generally not eligible for the long-term capital gain tax rate, but rather, is generally subject to income tax at the same rate as ordinary compensation income.[9] In this situation, where preferential long-term capital gains tax rates are not available, the tax benefit of deferred compensation to the recipient may be substantial.

Quantifying the tax benefit of deferral of compensation

The principal advantage of deferral is the ability to retain earnings in the foreign corporation and invest them such that they are not subject to tax on an annual basis, i.e., invest them on a pre-tax basis. Suppose that a taxpayer in the 35 percent bracket earns $100 of compensation today and defers it for five years, such that the foreign corporation can invest the money and earn a 10 percent return per year. The taxpayer would then have $161.05 and pay tax of $56.37, for an after-tax income of $104.68. Suppose there is another taxpayer who cannot defer compensation, but has access to the same investment opportunity. This taxpayer receives $100 in compensation today, pays tax of $35, and has only $65 to invest. He invests that amount at an after-tax rate of 6.5 percent, i.e. a 10 percent pretax rate less 35 percent tax on the earnings each year. At the end of five years, he will only have $89.06. The $15.62 ultimate difference in economic wealth between the taxpayer who could defer the compensation income for five years (whose deferred income in turn compounded at 10 percent per year), compared to the otherwise identically-situated taxpayer who was required to pay tax on the compensation income immediately (whose after-tax income compounded at 6.5 percent per year), can be analyzed as follows.

[9] Situations exist in which hedge funds are subject to ordinary income rates (e.g., if the fund makes a mark-to-market election under section 475(f). In general, compensation income is subject to employment tax (2.9 percent for amounts over $97,500 for 2007), however, while short-term capital gain is not. See the Present Law section of *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. This document is available on the internet at www.house.gov/jct.

In the deferral case, the employee can be understood at a conceptual level (by virtue of her agreement with her employer under which her deferred compensation grows at 10 percent per year) as if she also received $100 in cash compensation (but in her case not taxable income) immediately, and then set aside $35 of that $100 to fund her entire tax liability (which $35 in turn also was invested at 10 percent). Of course the employee did not actually receive cash upfront, but the effect of her agreement with her employer was to put her in the same economic position as if she did receive that cash and immediately invested it at a 10 percent rate. Each year the $100 (and therefore the employee's ultimate tax bill) would notionally grow at 10 percent, but so would the $35 component of that amount set aside to fund the employee's future tax bill. As a result, the $35 notionally set aside by the employee in the first period would be sufficient to pay her taxes at the end of the fifth year. This means that the employee's total after-tax wealth at the end of the fifth year would equal $65 (the portion of the $100 notionally received at the start that was not needed to fund her tax liability) compounded at the full pretax rate of 10 percent, or $104.68.

In other words, the incremental value of deferring income in this example is equivalent to the difference between investing $65–the *after-tax* value of the compensation–at the pre-tax interest rate (10 percent), rather than the after-tax rate (6.5 percent), for the five-year life of the deferral. More generally, any deferral of income can be analyzed in the same way: the value of deferral is equivalent to the value of investing the *after-tax* amount of the income over the period of the deferral at the *pre-tax* rate of return.[10] It is as if the taxpayer who can defer her income must pay tax currently on the deferred amount, but then can invest the after-tax proceeds on a tax-exempt basis.[11]

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[10] The proposition assumes that tax rates remain constant.

[11] This principle can also be understood as a special case of the well-known "Cary Brown theorem," which holds that, assuming constant tax rates, permitting an immediate deduction for the cost of a marginal asset that ordinarily would be purchased with after-tax dollars is equivalent to exempting the yield from the asset from tax. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* 300 (1948). In the income deferral case, the analog of the purchase price of an asset is the taxpayer's after-tax income, because in the base case assets are purchased with after-tax dollars. The value of income deferral then becomes the tax exemption of the yield from that after-tax income amount for the life of the deferral.

II. ECONOMIC DATA

In general

As mentioned above, alternative investment funds have been structured to accommodate the various tax concerns of their investors. One element of this structure is the decision to register the fund onshore, offshore, or in a structure with parallel onshore and offshore components. While other business reasons may exist for a fund to locate offshore, tax considerations may provide one reason for alternative investment funds to register offshore. This section provides data on the geographic distribution of two broad categories of alternative investment funds: hedge funds and private equity funds. The data relate to whether the fund is onshore -- meaning for this purpose, registered in the country where the fund is based -- or offshore -- meaning for this purpose, registered in a country other than where the fund is based.

Geographic distribution of hedge funds

As of January 2006, nearly 55 percent of global hedge funds were registered offshore, that is, in a country other than where the fund is based.[12] The vast majority, 92 percent, of offshore funds are registered in the British overseas territories of the Cayman Islands (63 percent), the British Virgin Islands (13 percent), Bermuda (11 percent), and the Bahamas (5 percent). The U.S. was the most popular onshore site, (with funds mostly registered in Delaware), home to 48 percent of those funds registered in onshore locations, followed by Ireland with 7 percent of all onshore funds. That is, U.S. based and registered funds represented 48 percent of all funds that were both registered in and based out of the same country.

The U.S. is the primary location for the management of hedge fund assets, as determined by the location of the hedge fund manager. The U.S. accounted for 63 percent of all assets under management in 2006, down from 82 percent in 2002. Europe and Asia have seen their shares of global hedge fund assets rise from 12 percent to more than 25 percent and from 5 percent to 8 percent, respectively, over that time.

Nearly half of all U.S. domiciled hedge fund managers are based in New York, managing a third of global hedge fund assets, down from 45 percent in 2002. California is home to 15 percent of the number of U.S. managers, followed by Connecticut, Illinois, and Florida with approximately 6 percent each. London is the world's second largest center for hedge fund managers with 21 percent of global assets under management in 2006. Other important European centers include France, Spain, and Switzerland. For Asia-Pacific funds, Australia leads with one-quarter of the region's hedge funds' $140 billion in assets under management as of the end of 2006. Following are the U.S. (with 23 percent), Japan (20 percent), U.K. (16 percent) and Hong Kong (14 percent).

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[12] International Financial Services, London, Hedge Fund: City Business Series, April 2007, available at http://www.ifsl.org.uk/uploads/CBS_Hedge_Funds_2007.pdf.

Geographic distribution of private equity funds

One study estimates that U.S. venture and buyout funds launched between 1991 and 2004 represented 59 percent (988 out of 1,673) of the total number of private equity funds worldwide during that time. European venture and buyout funds were home to nearly 16 percent of all funds (263). Just over one quarter of funds were either real estate funds without a location identified (144) or were located elsewhere in the world (278).[13]

This geographic distribution is confirmed by more recent data.[14] For 2006, the U.S. accounted for approximately 60 percent of global private equity investments with more than $220.4 billion, down from 67 percent in 2000. The U.S. share of funds raised declined from 69 percent to 47 percent over this period. The U.K. was the second largest market for private equity investments, attracting $51.4 billion for 14 percent of global investments. Other European countries attracting significant global private equity investment include France with 4 percent of all investments, Sweden with 2 percent, and Germany, Spain, and the Netherlands, with approximately 1 percent each. Europe as a whole represents 24 percent of the private equity investment market, up from 21 percent in 2000. The most significant growth for Europe has been as a source of private equity funds raised, increasing its share from 21 percent in 2000 to 44 percent in 2006.

The Asia-Pacific region has also attracted an increasing share of investments, growing from a 6 percent share in 2000 to a 14 percent share in 2006, even as its importance as a source of funds raised remained relatively constant, rising only modestly from 7 percent to 8 percent. Separate estimates show the Middle East Gulf Cooperation Council economies of Saudi Arabia, United Arab Emirates, Qatar, Kuwait, Bahrain, and Oman, increased their presence in private equity fundraising. These countries raised $10 billion in 2006, up from $5.7 billion in 2005. The entire Middle East and North Africa region accounted for approximately twice this amount.[15]

Seven of the top 10 private equity firms ranked by amount of capital raised for direct private equity investment between 2001 and 2006 are headquartered in the United States, including all of the top 5 firms. Three of these 7 firms are headquartered in New York, with one each in Washington, DC, Fort Worth, TX, Boston, MA, and Providence, RI. The other 3 firms in the top 10 are headquartered in London.[16]

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[13] Private Equity Intelligence, Ltd. 2006 "Value Creation and Carry Review", available at http://www.preqin.com/carry.aspx

[14] International Financial Services, London, Private Equity 2007: City Business Series, August 2007, available at http://www.ifsl.org.uk/uploads/CBS_Private_Equity_2007.pdf.

[15] Ithmar Capital and Dow Jones Private Equity, The Impact of Private Equity on the GCC: Edition I, 2007, available at http://www.ithmar.com/pdf/thought_leadership_reports.pdf

[16] International Financial Service, London, Private Equity 2007 (supra).

III. PRESENT LAW

A. Present Law and Background of the Unrelated Business Income Tax and Debt-Financed Income

Present law of the unrelated business income tax and debt-financed property rules

Overview of the unrelated business income tax

The Code imposes a tax, at ordinary corporate rates, on the income that a tax-exempt organization obtains from an "unrelated trade or business ... regularly carried on by it."[17] Most exempt organizations are subject to the tax.[18] Generally, "unrelated trade or business" is "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose."[19] The Code thus sets up a three-part test for determining whether income from an activity is subject to the unrelated business income tax: (1) the activity constitutes a trade or business; (2) the activity is regularly carried on; and (3) the activity is not substantially related to the organization's tax-exempt purposes. An organization that is subject to the unrelated business income tax and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Passive income, such as dividends, interest, royalties, certain rents, and certain gains and losses from the sale or exchange of property, is exempt from the unrelated business income tax.[20] In general, the exemption for such passive income applies unless the income is derived from debt-financed property[21] or is in the form of certain payments from certain 50-percent controlled subsidiaries.[22] Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental

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[17] Secs. 512(a)(1), 511(a)(1).

[18] Organizations subject to the unrelated business income tax include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2).

[19] Sec. 513(a).

[20] Sec. 512(b)(1)-(3), (5).

[21] Sec. 512(b)(4).

[22] Sec. 512(b)(13).

to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Overview of the debt-financed property rules

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Special rules apply in the case of an exempt organization that owns an interest in a partnership (or a pass-through entity taxed as a partnership) that holds debt-financed property.[23] In general, in such cases, if the partnership incurs acquisition indebtedness with respect to property that, if held directly by the exempt organization, would not qualify for an exception from the debt-financed property rules, the receipt of income by the exempt organization with respect to such property may result in recognition of unrelated debt-finance income.

Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.[24] Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by a qualified organization to acquire or improve real property (the "real property exception").[25]

Exception for debt-financed real property investments by qualified organizations

For purposes of the real property exception, a qualified organization is: (1) an educational organization described in section 170(b)(1)(A)(ii)[26] and its affiliated supporting organizations; (2) a qualified trust described in section 401(a) (hereinafter "pension funds"); (3) a title holding company described in section 501(c)(25) (insofar as it holds shares of organizations described in (1) or (2)[27]); or (4) a retirement income account described in section

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[23] Sec. 512(c).

[24] Sec. 514(c)(1).

[25] Sec. 514(c).

[26] This Code section generally describes an educational organization that operates as a school (i.e., "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on").

[27] Sec. 514(c)(9)(C) & (F).

403(b)(9).[28] To qualify for the real property exception, an acquisition or improvement by the qualified organization must meet several requirements. These include: (1) a requirement generally that the price of the property is a fixed amount determined as of the date of the acquisition or completion of the improvement; (2) restrictions against payment of the indebtedness of the arrangement being dependent upon the revenue, income, or profits derived from the property; (3) restrictions concerning sale-leaseback arrangements; and (4) in general, a prohibition against seller financing.[29]

Additional requirements must be met for the real property exception to apply where the real property is held by a partnership in which a qualified organization is a partner. To qualify for the real property exception, the partnership must meet all of the above-described general requirements and must meet one of the following three requirements: (1) all of the partners of the partnership are qualified organizations; (2) each allocation to a partner of the partnership which is a qualified organization is a qualified allocation (within the meaning of section 168(h)(6)); or (3) the partnership satisfies a rule prohibiting disproportionate allocations.[30]

The disproportionate allocation rule requires two things: first, that the organization satisfy what commonly is referred to as the "fractions rule," and second, that each allocation with respect to the partnership have substantial economic effect within the meaning of section 704(b)(2).[31] Under the fractions rule, the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of overall partnership loss for the taxable year for which such partner's loss share will be the smallest.[32] A partnership generally must satisfy the fractions rule on an actual basis and on a prospective basis for each taxable year of the partnership in which it holds debt-financed property and has at least one partner that is a qualified organization.[33] The fractions rule generally is intended to prevent the shifting of disproportionate income or gains to tax-exempt partners of the partnership or the shifting of disproportionate deductions, losses, or credits to taxable partners.

<u>Legislative history of the unrelated business income tax and debt-financed property rules</u>

<u>Business and debt-financed income prior to 1950</u>

Until the introduction of the unrelated business income tax in 1950, exempt organizations enjoyed a full exemption from Federal income tax. There was no statutory limitation on the

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[28] Sec. 514(c)(9)(C).

[29] Sec. 514(c)(9)(B)(i)-(v).

[30] Sec. 514(c)(9)(B)(vi) & (E).

[31] Sec. 514(c)(9)(B)(E)(i).

[32] Sec. 514(c)(9)(B)(E)(i)(I).

[33] Treas. Reg. sec. 1.514(c)-2(b)(2)(i).

amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. In court decisions, tax-exemption was extended to organizations that did not conduct any charitable programs, but rather operated commercial businesses for the benefit of a charitable organization. Tax exemption for such so called "feeder" organizations was recognized, for example in *Roche's Beach, Inc. v. Commissioner*,[34] and *C.F. Mueller Co. v. Commissioner*.[35]

In addition to the use of feeder corporations as a source of revenue, another common practice of exempt organizations in the years before 1950 was the acquisition of real estate with borrowed funds. In a typical transaction, a tax-exempt organization would borrow the entire purchase price of real property, lease the property back to the seller under a long-term lease, and service the loan with tax-free rental income from the lease.[36]

Revenue Act of 1950

As a response to these practices, in the Revenue Act of 1950 Congress subjected charitable organizations (not including churches), and certain other exempt organizations to tax on their unrelated business income.[37] The legislative history of the 1950 Act provides that "the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition."[38] Congress decided not to deny or revoke tax-exempt status solely because the organization carried on unrelated active business enterprises, but instead "merely [imposed] the same tax on income derived therefrom as is borne by their competitors."[39] The Congress excluded from the tax certain passive forms of income, concluding that such passive income was "not likely to result in serious competition for taxable businesses having similar income"[40] and

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[34] 96 F.2d 776 (2d Cir. 1938) (holding that a bathing beach business that turned its profits over to a charitable organization was exempt).

[35] 190 F.2d 120 (3d Cir. 1951) (upholding the exempt status of a corporation that acquired the C.F. Mueller pasta company, on the ground that the pasta company's profits were destined for the New York University School of Law's exempt programs).

[36] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[37] Revenue Act of 1950, Pub. L. No. 81-814, sec. 301. In 1951, Congress extended the unrelated business income tax to the income of State colleges and universities. Sec. 511(a)(2)(B).

[38] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). The Supreme Court has stated that the "undisputed purpose" of the unrelated business income tax is "to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed." *United States v. American Bar Endowment*, 477 U.S. 105, 114 (1986); *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986) ("Congress perceived a need to restrain the unfair competition fostered by the tax laws.").

[39] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 39 (1950).

"should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations."[41]

The 1950 Act also taxed as unrelated business income certain rents received in connection with the leveraged sale and leaseback of real estate.[42] Here, Congress cited three objections to such transactions: (1) "the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption since the only contribution it makes to the sale and lease is its tax exemption"; (2) unchecked, such transactions could result in exempt organizations owning "the great bulk of the commercial and industrial real estate in the country . . . lower[ing] drastically the rental income included in the corporate and individual income tax bases"; and (3) the "possibility . . . that the exempt organization has in effect sold part of its exemption . . . by . . . paying a higher price for the property or by charging lower rentals than a taxable business could charge."[43] This provision was a precursor to the present-law tax on unrelated debt-financed income.

Tax Reform Act of 1969

In the Tax Reform Act of 1969, Congress extended the unrelated business income tax to all exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities).[44] In addition, the 1969 Act expanded the tax on debt-financed income. The provision enacted in 1950 to tax income from certain leveraged sale-leaseback transactions involving real estate had proved ineffective, as taxpayers succeeded in structuring transactions that escaped the reach of the statute.[45]

The Supreme Court considered one such transaction in the *Clay Brown* case.[46] In *Clay Brown*, a corporate business was sold to a charitable organization, which made a small or no down payment and agreed to pay the balance of the purchase price to the former shareholders out of profits from the property. The charity liquidated the corporation and leased the business

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[40] S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).

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

[42] There was an exception for rental income from a lease of five years or less.

[43] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[44] The tax also applies to certain State colleges and universities and their wholly owned subsidiaries. Sec. 511(a)(2)(B).

[45] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

[46] *Commissioner v. Clay B. Brown*, 380 U.S. 563 (1965).

assets back to the sellers, who formed a new corporation to operate the business. The newly formed corporation paid a large portion of its business profits as deductible "rent" to the charity, which then paid most of these receipts back to the original owners as installment payments on the initial purchase price. The Supreme Court agreed with the taxpayer's characterization of the transaction. The original owners thereby succeeded in converting business income that would have been taxable at ordinary income rates to capital gains, while the exempt organization acquired the ownership of a business largely or wholly without the investment of its own funds. Thus, under the 1950 legislation, exempt organizations continued to be able to leverage exempt status to buy businesses and investments on credit, often at more than market price, without contributing much if anything to the transaction other than tax exemption.[47]

Citing principally to cases such as *Clay Brown* and the ability of taxable parties to convert ordinary income into capital gain through leveraged sale-leaseback transactions with tax-exempt organizations,[48] the Congress in 1969 expanded the unrelated debt-financed income rules to cover not only certain rents from debt-financed acquisitions of real property, but to tax in addition other debt-financed income such as interest, dividends, other rents, royalties, and certain gains and losses from any type of property. The 1969 Act provided for certain limited exceptions to the tax on debt-financed income, such as where the debt-financed property is related to the organization's exempt functions.

Enactment of the real property exception

In the Miscellaneous Revenue Act of 1980, Congress enacted an exception to the debt-financed income rules for certain real property investments by qualified pension trusts (the progenitor of the real property exception, described above). The exception did not apply, however, if any of five situations were present: (1) the acquisition price is not a fixed amount on the acquisition date; (2) the amount of indebtedness is dependent on the revenue, income, or profits derived from the debt-financed property; (3) the property is leased back to the seller (or a related party); (4) the property is acquired from or leased to a related person of the trust; and (5) the seller or person related to the trust provides nonrecourse financing, and the debt is subordinate to any other indebtedness on the property or the debt bore an interest rate significantly lower than that provided by unrelated parties.[49]

Congress believed that such an exception was warranted because "the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose --

[47] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

[48] S. Rep. No. 552, 91st Cong., 1st Sess. 62-63; H.R. Rep. No. 413, 91st Cong., 1st Sess. 44-46; Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

[49] Compare sec. 514(c)(9)(B)(i)-(v).

the payment of employee benefits."[50] Real estate investments are attractive "for diversification and to offset inflation. Debt financing is common in real estate investments." In addition, the exemption provided to pension trusts was appropriate because, unlike other exempt organizations, the assets of such trusts eventually would be "used to pay taxable benefits to individual recipients whereas the investment assets of other [exempt] organizations . . . are not likely to be used for the purpose of providing benefits taxable at individual rates." In other words, the exemption for qualified trusts generally resulted only in deferral of tax; unlike the exemption for other organizations. Congress also believed that the five limitations placed upon use of the exception would "eliminate the most egregious abuses addressed by the 1969 legislation."

In the Deficit Reduction Act of 1984, Congress extended the real property exception to educational organizations, finding that "educational organizations generally were unable to avoid taxation on income from real property acquired for investment purposes because few institutions had sufficient assets to purchase property not subject to debt."[51] At the same time, Congress layered on additional conditions, including an absolute bar on seller financing and an anti-abuse rule in the case of qualified organizations that were partners in partnerships investing in debt-financed real property. The new restrictions were needed because prior law was "inadequate to prevent the shifting of tax benefits between tax-exempt organizations and taxable entities."[52]

Between 1986 and 1988, Congress introduced and modified rules requiring that investments through a partnership satisfy a prohibition on disproportionate allocations, i.e., the requirements that each partnership allocation have substantive economic effect and that the partnership satisfy the "fractions rule."[53]

In 1993, Congress relaxed some of the conditions required to meet the real property exception. In general, leasebacks to the seller (or a disqualified person) are allowed if no more than 25 percent of the leasable floor space in a building is leased back and the lease is on commercially reasonable terms.[54] Seller financing is permitted if the financing is on commercially reasonable terms.[55] In addition, the fixed price restriction and the requirement that

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[50] S. Rep. No. 96-1036, 96st Cong., 2d Sess. 29 (1980).

[51] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 1151.

[52] *Id*. In the Tax Reform Act of 1986, Congress provided exempt status for certain title holding companies (section 501(c)(25)) and at the same time extended the real property exception to such companies.

[53] Sec. 514(c)(9)(B)(vi) & (E).

[54] Sec. 514(c)(9)(G)(i).

[55] Sec. 514(c)(9)(G)(ii).

indebtedness not be paid out of revenue, income, or profits of the acquired property are relaxed for certain sales by financial institutions.[56]

[56] Sec. 514(c)(9)(H).

B. Overview of U.S. International Tax Rules

Tax treatment of foreign activities of U.S. persons

In general

The United States employs a worldwide tax system under which U.S. citizens, residents, and corporations (collectively, "U.S. persons") generally are taxed on all income, whether derived in the United States or abroad. If a U.S. person is a shareholder of a foreign corporation, the U.S. person generally is subject to U.S. tax on its share of the corporation's income only when that income is distributed as a dividend to the U.S. person. Until that repatriation, the U.S. tax on the income generally is deferred. Certain anti-deferral regimes, however, may cause the U.S. person to be taxed on a current basis in the United States on certain categories of passive or highly mobile income derived by a foreign corporation, regardless of whether the income has been distributed as a dividend. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F[57] and the passive foreign investment company ("PFIC") rules.[58] These regimes are described below.

Subject to certain limitations, a foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[59]

Anti-deferral regimes

In general.–Generally, income derived indirectly by a U.S. person through a foreign corporation is subject to U.S. tax only when the income is distributed to the U.S. person because corporations generally are treated as separate taxable entities for Federal tax purposes. This deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income derived by certain corporations. These anti-deferral rules are intended to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, for most types of active business income earned abroad.

Subpart F.–Subpart F[60] applies when five or fewer U.S. persons control a foreign corporation. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that

[57] Secs. 951-964.

[58] Secs. 1291-1298.

[59] Secs. 901, 902, 904, 960, 1291(g).

[60] Secs. 951-964.

own at least 10 percent of the stock (measured by vote only).[61] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[62]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[63] insurance income,[64] and certain income relating to international boycotts and other violations of public policy.[65] Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[66]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income.

The U.S. 10-percent shareholders of a controlled foreign corporation also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in certain items of U.S. property.[67] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the controlled foreign corporation for use in the United States.[68] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[69]

Passive foreign investment companies.–The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross

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[61] Secs. 951(b), 957, 958.

[62] Sec. 951(a).

[63] Sec. 954.

[64] Sec. 953.

[65] Sec. 952(a)(3)-(5).

[66] Sec. 954.

[67] Secs. 951(a)(1)(B), 956.

[68] Sec. 956(c)(1).

[69] Sec. 956(c)(2).

income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[70] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[71] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[72] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[73]

Coordination.–Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a passive foreign investment company with respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a U.S. shareholder under section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules.

Foreign earned income and housing cost exclusions

A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs.[74] This exclusion applies regardless of whether any foreign tax is paid on the foreign earned income or housing costs. To qualify for these exclusions, an individual (a "qualified individual") must have a tax home in a foreign country and must be either (1) a U.S. citizen[75] who is a bona fide resident of a foreign

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[70] Sec. 1297.

[71] Secs. 1293-1295.

[72] Sec. 1291. This interest charge is imposed when a shareholder receives an excess distribution, which in general is a distribution in excess of 125 percent of the average amount received during the three preceding taxable years.

[73] Sec. 1296.

[74] Sec. 911.

[75] Generally, only U.S. citizens may qualify under the bona fide residence test. A U.S. resident alien who is a citizen of a country with which the United States has a tax treaty may, however, qualify for the section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision of the treaty.

country or countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or resident present in a foreign country or countries for at least 330 full days in any 12-consecutive-month period. The foreign earned income exclusion generally is available for a qualified individual's non-U.S. source earned income attributable to personal services performed by that individual during the period of foreign residence or presence described above. The maximum exclusion amount for 2007 is $85,700. A qualified individual also is allowed a deduction or an exclusion from gross income for the excess of reasonable foreign housing expenses paid or incurred by or on behalf of the individual over a base amount. The maximum amount of the housing exclusion in 2007 generally is $11,998 (computed as (1) 30 percent of the maximum foreign earned income exclusion amount less (2) a base amount equal to 16 percent of the maximum foreign earned income exclusion). Under guidance issued by the Treasury Department, the maximum housing cost exclusion amount has been increased for housing in many locations.[76]

Tax treatment of U.S. activities of foreign persons

In general

The United States asserts taxing jurisdiction over nonresident alien individuals and foreign corporations ("foreign persons") only with respect to income that has a sufficient nexus to the United States. Foreign persons are subject to net-basis U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.[77] Effectively connected income generally is taxed in the same manner and at the same rates as the income of a U.S. person.[78]

With a few exceptions, foreign persons are subject to a gross-basis U.S. tax at a 30-percent rate on certain categories of non-effectively-connected income derived from U.S. sources (interest, dividends, rents, royalties, and other similar types of income).[79] One major exception is that certain types of interest (for example, interest from certain bank deposits and from certain portfolio obligations) are not subject to the tax.[80] A foreign person's income from notional principal contracts (that is, swaps) also generally avoids U.S. tax because the source of the income generally is determined by the residence of the recipient of the income.[81] U.S.-source capital gains generally are not subject to gross-basis U.S. tax. The 30-percent tax generally is

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[76] Notice 2006-87, 2006-43 I.R.B. 766; Notice 2007-25, 2007-12 I.R.B. 760.

[77] Sec. 875.

[78] Secs. 871(b) and 882.

[79] Secs. 871 and 881.

[80] Secs. 871(h)-(i), 881(c)-(d).

[81] Treas. Reg. sec. 1.863-7(b)(1).

collected by means of withholding by the person making the payment to the foreign person receiving the income.[82] This gross-basis withholding tax may be reduced or eliminated by a bilateral income tax treaty between the United States and another country.

In general, every foreign person engaged in a U.S. trade or business during a taxable year is required to file an income tax return for that year even if the person does not have effectively connected income or U.S.-source income.[83]

Trading safe harbors

Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[84] Under these rules (sometimes referred to as "trading safe harbors"), trading in stock or securities or commodities by a foreign person through an independent agent such as a resident broker generally is not treated as the conduct of a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which the trading is effected. Trading in stock or securities or commodities for the foreign person's own account, whether by the foreign person or the foreign person's employees or through a resident broker or other agent (even if that agent has discretionary authority to make decisions in effecting the trading) also generally is not treated as the conduct of a U.S. business provided that the foreign person is not a dealer in stock or securities or commodities.

Branch profits tax

A foreign corporation that is engaged in a U.S. trade or business through a branch (rather than through a separate corporate subsidiary) generally is subject to U.S. tax on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation.[85] These branch level taxes are comparable to the second-level withholding taxes that generally would be imposed when a U.S. subsidiary of a foreign corporation paid interest or dividends to the foreign parent corporation. Income tax treaties may reduce or eliminate the branch profits tax.

FIRPTA

Special U.S. tax rules apply to foreign persons' gains attributable to dispositions of interests in U.S. real property.[86] A foreign person's gain or loss from the disposition of a U.S.

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[82] Secs. 1441, 1442.

[83] Treas. Reg. sec. 1.6012-1(b), -2(g).

[84] Sec. 864(b)(2).

[85] Sec. 884.

[86] The rules governing the imposition and collection of tax on foreign persons' dispositions of U.S. real property are included in a series of provisions that were enacted in 1980 and that are collectively

real property interest is taken into account for U.S. tax purposes as if the gain or loss were effectively connected with a trade or business within the United States during the taxable year.[87] Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons.

Earnings stripping

The Code includes certain rules, known as "thin capitalization" rules, intended to prevent foreign corporations from eliminating or inappropriately reducing the income of their U.S. subsidiaries through excessive interest deductions. Those rules provide, in part, that the interest paid or accrued by a domestic corporation is nondeductible if it is paid or accrued to a related party, no tax is imposed on the payment, and the domestic corporation has a debt-equity ratio exceeding 1.5 to one. The amount that is nondeductible generally is limited to the excess of the domestic corporation's net interest expense − that is, interest expense less interest income − over its taxable income (with certain adjustments).[88]

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referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA") (secs. 897, 1445, 6039C, and 6652(f)).

[87] Sec. 897(a).

[88] Sec. 163(j).

C. Overview of Ways to Defer Services Income

1. Qualified plans

<u>**In general**</u>

Deferred compensation occurs when the payment of compensation to a service provider is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the service provider's death, disability, or other termination of services, or is deferred for a specified period of time, such as five or ten years.

The Code provides tax-favored treatment for certain types of employer-sponsored deferred compensation arrangements that are designed primarily to provide employees with retirement income. These arrangements include qualified defined contribution and defined benefit pension plans (sec. 401(a)), qualified annuities (sec. 403(a)), tax-sheltered annuities (sec. 403(b)), savings incentive match plans for employees or "SIMPLE" plans (sec. 408(p)), simplified employee pensions or "SEPs" (sec. 408(k)), and eligible deferred compensation plans of State or local governmental employers (sec. 457(b)). These plans are referred to as qualified retirement plans.

In the case of a qualified retirement plan, employees do not include contributions in gross income until amounts are distributed, even though the arrangement is funded and benefits are nonforfeitable. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee's income. Contributions to a qualified plan, and earnings thereon, are held in a tax-exempt trust.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to be qualified and for favorable tax treatment to apply. These requirements include nondiscrimination rules that are intended to ensure that a qualified retirement plan covers a broad group of employees. The nondiscrimination requirements are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees.[89] Under a general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in

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[89] For purposes of the nondiscrimination requirements, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $100,000 (for 2007) or (b) at the election of the employer had compensation for the preceding year in excess of $100,000 (for 2007) and was in the top 20 percent of employees by compensation for such year (sec. 414(q)). A nonhighly compensated employee is an employee other than a highly compensated employee.

favor of highly compensated employees.[90] Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination requirement. For example, under the regulations applicable to qualified defined contribution plans and qualified defined benefit plans, the amount of contributions or benefits provided under the plan and the benefits, rights and features offered under the plan must be tested.[91]

Limits also apply on the amount of contributions that can be made to qualified plans and, in the case of defined benefit plans, on the amount that is payable annually from the plan. Limits also apply to the amount of an employer's deduction for contributions to qualified plans.

Qualified employer plans are also generally subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). For example, ERISA generally requires that the assets of a pension plan be held in a trust established for the exclusive purpose of providing plan benefits.

Qualified cash or deferred arrangements (section 401(k) plans)

Under present law, many defined contribution plans include a qualified cash or deferred arrangement (commonly referred to as a "401(k) plan"), under which employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual for any taxable year is $15,500 (for 2007). In applying this limitation, elective deferrals under 401(k) plans, tax-sheltered annuities, SEPs, and SIMPLE plans are aggregated. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan. As a result, the dollar limit on elective deferrals is increased for an individual who has attained age 50 by $5,000 (for 2007). An employee's elective deferrals must be fully vested. A special nondiscrimination test applies to elective deferrals under a 401(k) plan.

Tax-sheltered annuities (section 403(b) annuities)

A tax-sheltered annuity is also permitted to allow a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. As discussed above, the $15,500 annual limit on elective deferrals applies to elective deferral contributions to a tax-sheltered annuity. As with a 401(k) plan, special rules permit catch-up contributions to be made to a tax-sheltered annuity in the case of certain individuals, and special rules apply for purposes of nondiscrimination testing.

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[90] Secs. 401(a)(4), 403(b)(12), 404(a)(2), and 408(k)(3). A qualified retirement plan of a governmental employer is not subject to the nondiscrimination requirements. Special rules apply in the case of a SIMPLE plan to ensure that a broad group of employees are covered by the plan. Sec. 408(p)(2) and (4).

[91] See Treas. Reg. sec. 1.401(a)(4)-1.

Eligible deferred compensation plans of State and local governments (section 457 plans)

Compensation deferred under a section 457 plan of a State or local governmental employer is includible in income when paid. The maximum annual deferral under such a plan generally is the lesser of (1) $15,500 (for 2007) or (2) 100 percent of compensation. A special, higher limit applies for the last three years before a participant reaches normal retirement age (the "section 457 catch-up limit"). In the case of a section 457 plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of $5,000 (for 2007), unless a higher section 457 catch-up limit applies. Only contributions to section 457 plans are taken into account in applying these limits; contributions made to a qualified retirement plan or section 403(b) plan for an employee do not affect the amount that may be contributed to a section 457 plan for that employee. Thus, for example, a State or local government employee covered by both a section 457 plan and a section 401(k) or 403(b) plan can contribute up to $15,500 (for 2007) to each plan for a total of $31,000. In the case of a plan that fails to meet the dollar limitations or any other requirement of section 457 (an "ineligible plan"), compensation is includible in income for the first taxable year in which there is no substantial risk of forfeiture.[92]

2. Nonqualified deferred compensation

In general

A nonqualified deferred compensation arrangement is generally any deferred compensation arrangement that is not a qualified retirement plan. Nonqualified deferred compensation arrangements are contractual arrangements between a service recipient (e.g., an employer or a hedge fund) and a service provider (e.g., an employee or an entity that operates as a hedge fund manager) covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the service provider, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

ERISA contains exemptions from its requirements for certain nonqualified deferred compensation arrangements. Most nonqualified deferred compensation arrangements are designed to fall within these ERISA exemptions. Thus, nonqualified deferred compensation arrangements are generally not subject to the protections of ERISA. For example, there is no requirement that a nonqualified deferred compensation arrangement be funded by a trust established for the exclusive purpose of providing plan benefits.

The Code and ERISA do not limit the amount that can be deferred by a service provider under a nonqualified deferred compensation arrangement.

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[92] Sec. 457(f).

Tax treatment of service provider

In general

The American Jobs Creation Act of 2004[93] added section 409A to the Code which provides specific rules governing the tax treatment of nonqualified deferred compensation.[94] Prior to section 409A, there were no rules that specifically governed the tax treatment of nonqualified deferred compensation. In determining the tax treatment of nonqualified deferred compensation prior to enactment of section 409A, a variety of tax principles and Code provisions were relevant, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified employee annuities (sec. 403(c)). Section 409A does not override these tax principles and Code provisions. Thus, they are relevant in determining the tax treatment of nonqualified deferred compensation and are discussed below. Section 409A does not prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided under its rules.

Under section 409A, unless certain requirements are satisfied, amounts deferred under a nonqualified deferred compensation plan are currently includible in income to the extent not subject to a substantial risk of forfeiture. The requirements imposed under section 409A affect the way that nonqualified deferred compensation arrangements are now commonly structured.

General income inclusion rules

In the case of a cash-basis taxpayer, if the nonqualified deferred compensation arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451 (unless earlier income inclusion applies under section 409A).[95] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time.[96] Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

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[93] Pub. L. No. 108-357 (2004).

[94] Section 409A generally applies to amounts deferred after December 31, 2004.

[95] In contrast, if the taxpayer uses an accrual method of accounting, compensation is includible in gross income when all events have occurred which fix the right to receive such compensation and the amount thereof can be determined with reasonable accuracy. Treas. Reg. secs. 1.451-1 and 1.451-2.

[96] Compensation that is constructively received is includible in income regardless of whether the requirements of section 409A are met.

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Section 83 provides rules for the tax treatment of property transferred in connection with the performance of services and generally applies to a funded nonqualified deferred compensation arrangement.[97]

The economic benefit doctrine is based on the broad definition of gross income in the Code (sec. 61), which includes income in whatever form paid. Under the economic benefit doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is includible in the individual's gross income. For example, courts have applied the economic benefit doctrine to the receipt of stock options or the receipt of an interest in a trust.[98] A concept related to economic benefit is the cash equivalency doctrine.[99] Under this doctrine, if the right to receive a payment in the future is reduced to writing and is transferable, such as in the case of a note or a bond, the right is considered to be the equivalent of cash and the value of the right is includible in gross income.[100]

Section 409A

In general.–Under section 409A, all amounts deferred by a service provider under a nonqualified deferred compensation plan[101] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[102] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would

[97] Special rules apply under the Code in the case of nonexempt employee trusts and nonqualified employee annuities (i.e., trusts and annuities not meeting the requirements applicable to qualified retirement plans and annuities). Secs. 402(b) and 403(c). These provisions apply rules similar to those under section 83. Although these Code provisions predate the enactment of section 83 in 1969, they were amended at that time to reflect the enactment of section 83.

[98] *Commissioner v. Smith*, 324 U.S. 177 (1945); *E.T. Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (1952).

[99] In the case of nonqualified deferred compensation arrangements, these doctrines have largely been codified in the Code provisions discussed herein. However, because many of the legal precedents related to nonqualified deferred compensation predate these Code provisions, the economic benefit and cash equivalency doctrines are sometimes considered in analyzing the tax treatment of nonqualified deferred compensation.

[100] *See, e.g., Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

[101] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

[102] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Under regulations, the term "service provider" includes an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in sec. 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, or qualified personal service corporation (as defined in sec. 448(d)(2)) for any taxable year in which such individual or entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting.[103] Section 409A does not apply to a service provider that provides significant services to at least two service recipients that are not related to each other or the service provider. This exclusion does not apply to a service provider who is an employee or a director of a corporation (or similar position in the case of an entity that is not a corporation).[104] In addition, the exclusion does not apply to an entity that operates as the manager of a hedge fund or private equity fund. This is because the exclusion does not apply to the extent that a service provider provides management services to a service recipient. Management services for this purpose means services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets, such as a hedge fund.[105]

For purposes of section 409A, a nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan[106] or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

The regulations also provide that certain other types of plans are not considered deferred compensation, and thus are not subject to section 409A. For example, if a service recipient transfers property to a service provider, there is no deferral of compensation merely because the value of the property is either not includible in income under section 83 by reason of the property being substantially nonvested or is includible in income because of a valid section 83(b) election.[107] Another exception applies to amounts that are not deferred beyond a short period of

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[103] Treas. Reg. Sec. 1.409A-1(f)(1).

[104] Treas. Reg. Sec. 1.409A-1(f)(2).

[105] Treas. Reg. Sec. 1.409A-1(f)(2)(iv).

[106] A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan. A tax-exempt or governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

[107] Treas. Reg. Sec. 1.409A-1(b)(6).

time after the amount is no longer subject to a substantial risk of forfeiture.[108] Under this exception, there generally is no deferral for purposes of section 409A if the service provider actually or constructively receives the amount on or before the last day of the applicable 2½ month period. The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of: (1) the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; or (2) the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. Special rules apply in the case of stock options.[109]

The regulations provide exclusions from the definition of nonqualified deferred compensation for individuals who participate in certain foreign plans, including plans covered by an applicable treaty and broad-based foreign retirement plans.[110] In the case of a U.S. citizen or lawful permanent alien, nonqualified deferred compensation does not include a broad-based foreign retirement plan, but only with respect to the portion of the plan that provides for nonelective deferral of foreign earned income and subject to limitations on the annual amount deferred under the plan or the annual amount payable under the plan. In general, foreign earned income refers to amounts received by an individual from sources within a foreign country that constitutes earned income attributable to services.

Permissible distribution events.–Under section 409A, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary, may not permit acceleration of a distribution. In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees[111] of publicly-traded corporations.

Deferral elections.–Section 409A requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. The time and form of distributions

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[108] Treas. Reg. Sec. 1.409A-1(b)(4).

[109] Treas. Reg. Sec. 1.409A-1(b)(5).

[110] Treas. Reg. Sec. 1.409A-1(a)(3).

[111] Key employees are defined in section 416(i) and generally include officers (limited to 50 employees) having annual compensation greater than $145,000 (in 2007), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

must be specified at the time of initial deferral. A plan may allow changes in the time and form of distributions subject to certain requirements.

Back-to-back arrangements.–Back-to-back service recipients (i.e., situations under which an entity receives services from a service provider such as an employee, and the entity in turn provides services to a client) that involve back-to-back nonqualified deferred compensation arrangements (i.e., the fees payable by the client are deferred at both the entity level and the employee level) are subject to special rules under section 409A. For example, the final regulations generally permit the deferral agreement between the entity and its client to treat as a permissible distribution event those events that are specified as distribution events in the deferral agreement between the entity and its employee. Thus, if separation from employment is a specified distribution event between the entity and the employee, the employee's separation is a permissible distribution event for the deferral agreement between the entity and its client.[112]

Timing of the service recipient's deduction

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[113] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the service provider is deductible by the service recipient for the taxable year in which the amount is includible in the service provider's income.[114]

Employment taxes and reporting

In the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal

[112] Treas. Reg. Sec. 1.409A-3(i)(6).

[113] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

[114] In the case of a publicly held corporation, no deduction is allowed for a taxable year for remuneration with respect to a covered employee to the extent that the remuneration exceeds $1 million. Code sec. 162(m). The Code defines the term "covered employee" in part by reference to Federal securities law. In light of changes to Federal securities law, the Internal Revenue Service interprets the term covered employee as the principal executive officer of the taxpayer as of the close of the taxable year or the 3 most highly compensated employees of the taxpayer for the taxable year whose compensation must be disclosed to the taxpayer's shareholders (other than the principal executive officer or the principal financial officer). Notice 2007-49, 2007-25 I.R.B. 1429. For purposes of the deduction limit, remuneration generally includes all remuneration for which a deduction is otherwise allowable, although commission-based compensation and certain performance-based compensation are not subject to the limit. Remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of the compensation is deferred until after termination of employment.

Insurance Contributions Act ("FICA"), consisting of social security tax and Medicare tax. However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

In the case of an employee, nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee's income as discussed above. In addition, amounts includible in income are required to be reported on the employee's Form W-2 for the year includible in income. Income tax withholding and Form W-2 reporting are required even if the employee has already terminated employment. Income tax withholding and Form W-2 reporting are required when amounts are includible in income even if no actual payments are made to the employee.[115]

In the case of a service provider who is not an employee, nonqualified deferred compensation amounts includible in income generally are required to be reported on a Form 1099 for the year includible in income. Income tax withholding generally does not apply to such amounts.

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation of employees.[116] In general, nonqualified deferred compensation is subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by the timing of income inclusion.

In the case of a self-employed individual, nonqualified deferred compensation amounts that are includible in income are also taken into account in determining net earnings from self-employment for social security and Medicare tax purposes unless an exception applies.

The Code requires annual reporting to the IRS of amounts deferred even if such amounts are not currently includible in income for that taxable year.[117] The IRS has postponed the effective date of the statutory requirement and announced that an employer (or other payor) is

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[115] The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.

[116] Because nonqualified deferred compensation arrangements generally cover only highly paid employees, the other compensation paid to the employee during the year generally exceeds the social security wage base. In that case, nonqualified deferred compensation amounts are subject only to Medicare tax.

[117] Sec. 6051(a)(13).

not required for 2005 and 2006 to report amounts deferred during the year under a nonqualified deferred compensation plan subject to section 409A.[118]

Offshore arrangements

In general

The requirements under section 409A apply in the case of deferred compensation of a U.S. person participating in offshore operations such as a hedge fund located outside of the U.S. The general requirements of section 409A (i.e., the rules relating to elections, distributions and no acceleration of benefits) apply similarly to U.S. persons whether their activities are conducted in the United States or abroad.[119]

Foreign trusts

Section 409A requires current income inclusion in the case of certain offshore funding of nonqualified deferred compensation. Under section 409A, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property.

Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

[118] Notice 2006-100, 2006-51 I.R.B. 1109.

[119] As discussed above, exceptions apply in the case of certain foreign plans.

IV. ISSUES AND ANALYSIS

A. Issues and Analysis Relating to the Unrelated Business Income Tax and Debt-Financed Income

Use of offshore corporations to "block" unrelated business income tax

As discussed previously, the Code imposes a tax (the unrelated business income tax, or "UBIT"), at ordinary corporate rates, on an exempt organization's unrelated business taxable income ("UBTI"). An organization's UBTI includes the organization's unrelated debt-financed income.

In the absence of planning, exempt organizations that invest in an investment partnership may have adverse tax consequences from the partnership's receipt (directly or through one or more partnerships) of certain items of income related to the partnership's portfolio investments. However, the IRS has concluded in a series of private letter rulings that, where UBTI-producing assets are owned by a corporation, or an entity that elects to be treated as a corporation for Federal tax purposes, and an exempt organization invests directly or indirectly in such corporation or entity, the exempt organization generally will not recognize UBTI as a result of the investment. Under such circumstances, the separate existence of the corporation or entity generally will be respected, and the exempt organization generally will be treated as receiving only passive dividend income that is excluded from the organization's UBTI. When such entities are interposed between an exempt organization investor and assets that would give rise to UBTI if owned by the exempt organization directly (or through a pass-through entity) they commonly are referred to as "UBIT blockers" or "blocker corporations." Because the assets of hedge funds and private equity funds frequently are debt-financed, exempt organizations that invest in such funds often use UBIT blockers to avoid attribution of the funds' acquisition indebtedness to the exempt organization and thereby to avoid recognition of UBTI.

UBIT blockers may be established offshore in tax haven jurisdictions to avoid or minimize tax at the blocker corporation level.[120] Most hedge funds and other alternative investment vehicles organize their affairs to comply with the securities trading "safe harbor" of section 864(b), so that little if any of the income is subject to U.S. net income tax in the hands of an offshore blocker corporation or any other foreign investor. An offshore blocker corporation in turn may be a PFIC for U.S. tax purposes, but income from a PFIC is not UBTI in the hands of a U.S. tax-exempt organization.[121]

[120] There may be methods by which an exempt organization can "block" UBIT without investing through an offshore corporation and without incurring an entity-level tax, such as by making certain investments in REITs.

[121] If a blocker corporation were subject to U.S. corporate tax on income that would be UBTI if derived directly by a tax-exempt organization, the use of the blocker corporation may not reduce the total U.S. tax liability attributable to an investment. In that case, avoidance of the administrative burdens of complying with the UBTI rules and similar concerns, rather than reduction of total tax liability, may be a principal reason for use of a blocker corporation. See Robert D. Blashek & Scot A. McLean, *Investments*

Some argue that the use of offshore UBIT blockers creates inequities, because it allows for avoidance of UBIT by sophisticated organizations that can afford complex tax planning, whereas less sophisticated organizations that wish to invest in debt-financed or other UBTI-producing property must pay tax or not make the investment. Others argue that the ability to block UBIT by investing through blocker corporations established in tax haven jurisdictions results in the investment of capital offshore rather than domestically, and that this result is undesirable.

On the other hand, some argue that recognition of the separate legal existence of a corporate entity, even if established offshore, is a bedrock principle of U.S. tax law and should not be modified in the UBIT context. In the context of debt-financed assets, some also argue that where an exempt organization investor is not liable for acquisition indebtedness incurred by a blocker corporation (or an entity in which the blocker corporation holds an interest), such indebtedness should not be attributed to the exempt organization and thereby give rise to UBTI.

The unrelated debt-financed income rules

The unrelated debt-financed income rules were expanded in 1969 to tax not only certain rents from debt-financed acquisitions in real property, but to tax in addition other debt-financed income such as interest, dividends, other rents, royalties, and certain gains and losses from any type of property. Some argue that, in enacting the broader debt-financed income rules in 1969, the Congress appeared to have been reacting principally to certain specific sale-leaseback arrangements involving the sale of assets by taxable persons to exempt organizations that were perceived to be abusive. They argue, for example, that the rules were an overbroad reaction to a specific problem, do not have a sound policy basis, and either should be repealed or substantially modified.[122] Others, however, argue that in enacting the debt-financed income rules, the Congress believed that the rules were necessary to prevent exempt organizations from using debt to leverage tax-exempt status.[123] For example, in testimony before the Senate Finance Committee in 1982, the Treasury Department, opposing a proposed exception to the unrelated debt-financed income rules, argued that the rules help prevent unintended tax benefits from tax-exempt status, including the shifting of benefits of exempt status to taxable parties.[124]

Another argument sometimes made in opposition to the debt-financed income rules is that the rules may in certain cases treat similar transactions differently, because an exempt

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in 'Pass-Through' Portfolio Companies by Private Equity Partnerships: Tax Strategies and Structuring, 704 Practicing Law Institute/Tax 689 (June 2006), p. 789.

[122] See, e.g., Suzanne Ross McDowell, *Taxation of Unrelated Debt-Financed Income*, The Exempt Organization Tax Review (Vol. 34, No. 2), November 2001, at 210.

[123] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31-32 (1950).

[124] Statement of William McKee, Tax Legislative Counsel, Department of the Treasury, *1981-92 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 97th Cong., 2d Sess. 54 (1982).

organization may be able to replicate the economic consequences of acquisition indebtedness through a derivative investment that would not be treated as debt under the debt-financed income rules. As a result, the rules have been described as creating "'traps for the unwary' and opportunities for the well-advised."[125]

<u>The real property exception to the unrelated debt-financed income rules</u>

The unrelated debt-financed income rules include an exception for certain investments in real property by qualified organizations.

When the real estate exception first was enacted for qualified pension trusts in 1980, the Treasury Department did not oppose its enactment. Consistent with Congress' rationale for limiting the real property exception to pension funds, the Treasury Department testified that an exception limited to pension funds could be justified, because exempting investment income was a primary reason for such funds' exemption from income tax.[126] However, the Treasury Department opposed the subsequent extension of the real property exception to schools. The Treasury Department argued, for example, that providing an exception for investments by section 501(c)(3) schools would result in permanent exemption from income, whereas the exception for investments by pension funds results only in deferral of income recognition, because the income generally will be taxed to individuals upon receipt of distributions. In addition, the Treasury Department argued that there is no basis for providing an exception for schools but not for other section 501(c)(3) organizations, and likened such an exception to "piecemeal" repeal of the unrelated debt-financed income rules.[127] Finally, the Treasury Department cautioned that expansion of the real property exception could lead others to seek exceptions for investments in other types of property.[128] Commentators similarly have argued that there is no principled basis for providing an exception for investments in real property by section 501(c)(3) schools, while not providing such an exception for investments by other charitable organizations or for investments in other types of property.

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[125] McDowell, *supra*, at 212 (arguing that well-advised organizations oftentimes can structure leveraged investments that are not treated as debt-financed under the unrelated debt-financed income rules, but which have similar economic consequences to investments that, if made, would be treated as debt-financed).

[126] Statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury, *Five Miscellaneous Tax Bills: Hearings on S. 650 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 96th Cong., 2d Sess. 298 (1980).

[127] Statement of William McKee, Tax Legislative Counsel, Department of the Treasury, *1981-92 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 97th Cong., 2d Sess. 54-55 (1982).

[128] Statement of Robert G. Woodward, Acting Tax Legislative Counsel, Department of the Treasury, *Hearings before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee*, 98th Cong., 1st Sess. 88-89 (1983).

Some also argue that the mechanics of the real property exception, in particular the fractions rule, are overly complex and impose unfair burdens on qualified organizations.[129] They argue, for example, that the requirement that the fractions rule be satisfied hypothetically on a prospective basis for future years of a partnership creates hardships in structuring what ordinarily would be routine real-estate investment transactions. Others, however, argue that qualified organizations today regularly structure investments that satisfy the fractions rule, and that the rule is necessary to prevent the inappropriate shifting of benefits from tax-exempt partners to taxable partners.

[129] See William H. Weigel, *Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)*, 50 Tax Lawyer 3 (1996-1997), at 632-635; see generally Arthur A. Feder & Joel Scharfstein, *Leveraged Investment in Real Property through Partnerships by Tax Exempt Organizations after the Revenue Act of 1987 -- A Lesson in How the Legislative Process Should Not Work*, 42 Tax Lawyer 55 (Fall 1988).

B. Issues and Analysis Relating to U.S. International Tax Rules

Tax rules applicable to U.S. persons

Investment in alternative investment vehicles

Taxable U.S. persons that invest in alternative investment vehicles may have little or no reason for investing in those vehicles through non-U.S. entities (referred to below as "foreign feeders" or "foreign feeder corporations"). The United States generally taxes U.S. persons on a worldwide basis. Although a U.S. person's income derived through a foreign corporation generally is not subject to U.S. tax until the income is distributed as a dividend, anti-deferral rules may impose current U.S. tax or may eliminate the benefit of deferral. More specifically, either the PFIC or the subpart F rules are likely to apply if U.S. persons invest in alternative investment vehicles through foreign feeder corporations. Foreign feeder corporations may be PFICs because they have primarily passive income or assets or may be controlled foreign corporations if they are majority owned by a small number of U.S. persons.

Taxable U.S. persons also may be discouraged from organizing foreign feeder corporations because those corporations may be subject to U.S. corporate-level taxes on U.S.-source income.[130] These U.S. corporate-level taxes may constitute an added layer of tax if the alternative to investing in an alternative investment vehicle through a foreign feeder is to do so directly or through a partnership.

It has been suggested that a U.S. individual investor in a hedge fund could seek to avoid limits on the deductibility of management fees paid to investment managers by investing in the vehicle through a foreign feeder corporation that would be treated as a PFIC.[131] The advantages of avoiding the deductibility limits would need to be compared with the disadvantages of being subject to the PFIC rules.

Management of alternative investment vehicles

Taxable U.S. individuals who manage alternative investment vehicles also may find it difficult to move the income from that management business offshore. First, individual U.S. taxpayers pay federal income tax on their worldwide incomes. Relocating abroad by itself generally would not, apart from the foreign earned income exclusion allowed by section 911, reduce the federal tax liability of a U.S. individual employee of, or a partner in, an investment management firm. Second, organizing the management firm as a foreign corporation generally would not reduce the federal tax liability of that entity or its owners to the extent that the entity's

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[130] These taxes could include net-basis income tax on income effectively connected with a U.S. trade or business; branch profits tax on U.S. earnings and profits shifted out of, and interested deducted by, a U.S. branch; and gross-basis withholding tax on payments of certain U.S.-source amounts such as dividends.

[131] Andrew W. Needham & Christian Brause, *Hedge Funds,* BNA Tax Management Portfolio 736 at VIII.A.2.

employees and activities are in the United States. In many circumstances, a foreign corporation with employees and activities in the United States would be considered to have a trade or business in the United States if the corporation's activities did not satisfy the requirements of the trading safe harbors of section 864(b), and that trade or business could give rise to income subject to tax on a net basis by the United States. Moreover, for U.S. owners of a foreign corporation, the PFIC rules generally eliminate the benefit of deferral of U.S. tax if the corporation has primarily passive income or assets. Similarly, under the subpart F rules U.S. owners of a foreign corporation that is a controlled foreign corporation generally lose the benefit of deferral of U.S. federal tax on passive or highly mobile income.

Although taxable U.S. managers of alternative investment vehicles may find it difficult to avoid U.S. tax on the income of that management business, there may be a U.S. tax advantage to organizing an active public company as a foreign entity. A U.S. corporation that operates abroad through foreign entities may have difficulty avoiding net-basis U.S. income tax if it moves earnings from one foreign entity to another or if earnings are distributed from a foreign entity to the U.S. corporation. If instead the parent corporation is organized in a foreign jurisdiction, this net-basis U.S. income tax can be avoided (assuming the parent corporation is not itself a controlled foreign corporation).

Tax rules applicable to foreign persons

In general

Foreign persons that invest in U.S.-based alternative investment vehicles often do so through foreign feeder corporations. In the absence of planning, a foreign investor in a U.S.-based investment partnership with U.S.-source income might have U.S. effectively connected income from various sources, including its share of the U.S. trade or business income of an operating partnership; income from the investment partnership's sale of a U.S. real property interest; and fee income related to management services provided to operating companies by the investment partnership. As described below, however, hedge funds and similar vehicles generally rely on the section 864(b) trading safe harbors to avoid creating U.S. effectively income for foreign investors. To the extent effectively connected income cannot be avoided, use of a foreign feeder may allow a foreign investor to avoid U.S. tax return filing obligations and becoming subject to U.S. tax directly (but not, as described immediately below, indirectly) on U.S. effectively connected income.

Although a foreign investor in a U.S.-based investment partnership may avoid direct imposition of U.S. tax on effectively connected income by investing through a foreign feeder, the overall U.S. tax burden related to the investment may not be reduced. To the extent the foreign investor would have had effectively connected income had the investor invested directly (or through a partnership), the foreign feeder corporation itself generally will have effectively connected income. In particular, a foreign feeder corporation may have effectively connected income from various fees received by fund managers for services related to a fund's portfolio

company holdings.[132] Moreover, a foreign corporation, unlike a foreign individual, may be subject to branch profits tax on certain amounts. Gross-basis withholding tax on dividend and other payments apply whether payments are made to foreign individual investors or to foreign feeders. The rate of withholding tax on these payments may vary if a foreign feeder corporation is organized in a different jurisdiction from the jurisdiction in which a foreign investor is a resident because the rate may be governed by different tax treaties or may be 30 percent if no treaty is available in a particular case.

As a practical matter, hedge funds and similar vehicles in many cases may avoid withholding tax by holding notional principal contracts the income of which is treated as foreign source if derived by a foreign person. It has been reported that the IRS is investigating whether financial instruments that taxpayers have treated as notional principal contracts instead should be characterized as securities lending transactions that produce U.S.-source dividend income subject to gross-basis withholding tax.[133]

Even if the aggregate U.S. tax burden is not reduced when a foreign investor makes an investment in a U.S.-based vehicle through a foreign feeder corporation rather than directly or through a partnership, arranging the investment through a corporation may allow the investor to avoid the obligation to file a U.S. tax return. The investor would have this obligation if it invested directly or through a partnership in a U.S.-based vehicle and were engaged, directly or through the partnership or tiers of partnerships, in a U.S. trade or business.

Trading safe harbors

Although in theory foreign investors and foreign feeder corporations may have U.S. effectively connected income from certain management fees, gains from U.S. real property sales, and operating partnership income derived by hedge funds and similar investment vehicles, these funds generally rely on the section 864(b) trading safe harbors to avoid creating effectively connected income related to U.S.-based financial transactions. Under these safe harbors, hedge fund partnerships, feeder corporations, and, by extension, foreign investors are not treated as engaged in a U.S. trade or business, and therefore avoid effectively connected income, if their U.S. activities are restricted to trading in securities or commodities through the fund's management company. Some commentators have argued, however, that hedge funds that engage in lending activities (as opposed or in addition to securities and commodities trading) should not,

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[132] To avoid creating effectively connected fee income for foreign investors, many funds provide fee offset arrangements under which all fee income is segregated at the level of the fund manager in exchange for reductions in the management fee or carried interest distributions payable to the manager. An issue is whether these fee offset arrangements should be disregarded under the assignment of income doctrine or related substance-over-form arguments. See Andrew W. Needham & Anita Beth Adams, *Private Equity Funds,* BNA Tax Management Portfolio 735 at VII.C.3.

[133] Anita Raghavan, "IRS Probes Tax Goal of Derivatives,"*Wall Street Journal*, July 19, 2007; p. C1.

as a policy matter and under a reasonable interpretation of case law and Treasury regulations, satisfy the trading safe harbor requirements.[134]

[134] E.g., Lee A. Sheppard, "Neither a Dealer Nor a Lender Be, Part 2: Hedge Fund Lending," *Tax Notes*, Aug. 15, 2005, p. 729.

C. Issues and Analysis Relating to Nonqualified Deferred Compensation

In general

Nonqualified deferred compensation is a common form of executive compensation. From the executive's perspective, the desire to defer taxes is generally the key motivating factor behind deferred compensation. Individuals may want to defer compensation to a future date because they believe that their rate of tax will be lower in the future than it is currently, thus resulting in payment of lower taxes than if the compensation had been received currently. To the extent that the deferral is credited with earnings, an additional advantage is the pre-tax compounding of such earnings. Individuals may defer compensation in order to provide a future income stream in retirement. ERISA's exemptions for nonqualified deferred compensation arrangements allow great flexibility in designing plans and individual arrangements.

As discussed, fund managers' interests may be structured as a contractual arrangement to pay compensation based on the profits of the fund (as opposed to an ownership interest in the fund). In such cases, the compensation may be deferred. Questions have been raised as to whether deferral of the compensation for management services is appropriate in the case of an offshore structure.[135]

Magnitude of deferrals

Some argue that nonqualified deferred compensation is merely an avoidance of current income taxation and that any amount of deferral should be prohibited. Others point to the amount of compensation that is deferred in certain cases as raising tax or social policy concerns. Much attention has been focused on the large amounts of compensation deferred offshore. While many would view this as inappropriate, it may be argued that the deferral opportunities for fund managers offshore are no different than for other individuals or entities providing services, such as key corporate executives. Nonqualified deferred compensation is a common compensation arrangement for executives in all types of industries, regardless of whether the executive's employer is a U.S. or foreign entity.

As discussed above, neither the Code nor ERISA limit the amount of nonqualified deferred compensation. Because the service recipient (e.g., the employer or the investment fund) is denied a deduction for deferred compensation until the service provider (e.g., the employee or the fund manager) includes the compensation in income, in the case of a payor that is a U.S. taxpayer, there is often said to be a tension between the interests of the service provider and the service recipient that will result in an appropriate limit on deferred compensation. It is argued that this tension is not present in the case of offshore deferrals by hedge fund managers because

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[135] See Jenny Anderson, "Managers Use Hedge Funds as Big I.R.A.'s," *New York Times*, April 17, 2007. See also section 536 of H.R. 1591 (An act making emergency supplemental appropriations for the fiscal year ending September 30, 2007, and for other purposes), as passed by the Senate, which contains a provision that would generally impose a $1 million annual limit on nonqualified deferred compensation.

the deferral agreement is between the fund manager and a foreign feeder corporation. The foreign feeder corporation is an entity that is not a U.S. taxpayer and the shareholders of which are either U.S. tax-exempt entities or are not U.S. taxpayers. As a result, the foreign feeder corporation and its shareholders are indifferent to the availability of a U.S. tax deduction for compensation. In contrast, deferral agreements are not typically entered into between the fund manager and the domestic feeder fund or the master investment fund. This is because U.S. taxpayers, directly or indirectly, hold interests in these entities, which typically are organized as partnerships, and these U.S. taxpayers are sensitive to the deduction timing issue.

Many believe that it is inappropriate to allow deferral of income in cases in which the deferral of the payor's deduction has no consequence (e.g., in the case of an entity that pays no U.S. tax). Present law recognizes that different rules may be appropriate when the payer is not a taxable entity. For example, the Code provides more restrictive rules for deferred compensation plans of governmental and tax-exempt employers than for taxable entities.[136] Some believe that allowing deferral of income is only appropriate when a corresponding deduction is also deferred. Of course, this issue is not unique to hedge funds or other investment management firms. A U.S. citizen working for a foreign employer may be permitted to defer compensation even though the foreign entity does not forego or postpone a deduction under its applicable tax laws.

Some believe that the theoretical tension between the employer's interest in a current tax deduction and the employee's interest in deferring tax has little, if any, effect on the amount of compensation deferred by executives. It is pointed out that the tension in the corporate context is often more theoretical than real, because many corporations have net operating losses and do not currently pay taxes, there may be a business purpose to allow the deferral (such as the desire to provide a retention incentive), and because the employer may wish to accommodate the desire of the employee for deferral in order to attract and retain qualified executives.[137]

As previously discussed, the rules under section 409A provide requirements as to elections and permissible distribution events. Section 409A was enacted to address concerns relating to inappropriate access of executives to amounts deferred and does not limit the amount of compensation that can be deferred. Some believe that deferrals under an offshore hedge fund arrangement are not inappropriate as long as the deferrals satisfy the requirements of section 409A. Others believe that section 409A generally should be broadened to restrict the amount of compensation that can be deferred. They believe that a limit on the amount that can be deferred is appropriate given the relatively low limits that are imposed on amounts deferred under a qualified retirement plan. For example, rank and file employees who participate in a section 401(k) plan can defer no more than $15,500 in 2007, while executives in a nonqualified deferred compensation plan can defer an unlimited amount. Some also believe that additional restrictions

[136] Sec. 457(f).

[137] Additionally, in the case of a publicly traded corporation, the section 162(m) limit on the deductibility of remuneration paid to a covered employee provides an incentive for the corporation and covered employee to structure compensation in excess of the limit as deferred compensation since such compensation is not subject to the deduction limit.

on nonqualified deferred compensation are appropriate as such plans are free of most of the restrictions that apply to qualified employer plans (e.g., nondiscrimination rules).

While some argue that allowing unlimited amounts of deferral through an offshore entity is inappropriate, it may be possible that the tax benefits that are achieved by deferring compensation paid by an offshore entity can also be achieved through other structures. For example, a foreign corporation could grant the fund managers options in the foreign corporation which could defer recognition of ordinary income until the options are exercised. However, if the corporation is a passive foreign investment company, the tax advantages of deferral may be negated.[138]

Compliance issues/reporting

Some have raised the issue that there may be compliance issues under section 409A in the fund manager context, especially if there are foreign payors of nonqualified deferred compensation. On the other hand, the significant consequences of failing to comply with section 409A (current income inclusion, plus an additional 20-percent tax, plus interest) may provide sufficient incentive for compliance, at least if there is a belief that detection of noncompliance by the IRS is reasonably likely.

Present law requires annual reporting of amounts deferred under a nonqualified deferred compensation plan even if amounts are not currently includible in income. The implementation of this requirement has been delayed by the Treasury Department. Final regulations issued by the Department of Treasury do not address the reporting requirements applicable to service recipients providing nonqualified deferred compensation covered by section 409A. Under Notice 2006-100, 2006-51 I.R.B. 1109, the IRS announced that an employer (or other payor) is not required for 2005 and 2006 to report amounts deferred during the year under a nonqualified deferred compensation plan subject to section 409A. Many believe that requiring reporting of amounts deferred to the IRS, even if the taxpayer takes the position that such amounts are not currently includible in income, could provide the IRS greater information regarding such arrangements. In most cases, the IRS does not have any information reported to it regarding amounts deferred, and therefore, no indication that a particular arrangement should be examined.[139] This argument is present in the fund manager context as the IRS has little

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[138] Proposed Treasury regulations under section 1291 provide that (1) an option to acquire stock in a passive foreign investment company is treated as stock for purposes of applying the excess distribution rules to the disposition of the option and (2) the holding period of a share of passive foreign investment company stock acquired by the exercise of an option includes the period the option was held. Section 1291(a)(2) provides that gain recognized on the sale of stock of a passive foreign investment company is treated as an excess distribution. Accordingly, under the tax-plus-interest rules of section 1291 and the accompanying proposed regulations, the sale of an option or the exercise of an option followed by the immediate sale of the underlying stock generally would trigger an interest charge computed based on the taxpayer's option and stock holding period.

[139] Securities and Exchange Commission regulations require disclosure in public filings of certain information related to nonqualified deferred compensation. *See e.g.*, 17 C.F.R. § 229.402(i).

information as to such arrangements. Many believe that the reporting requirement under present law could provide the IRS with information necessary to better examine such arrangements and that the Treasury Department should require compliance with the statutory requirement.

Offshore trusts

As previously discussed, section 409A provides for income inclusion in the case that assets restricted to deferred compensation are set aside in an offshore trust or similar arrangement. This provision was specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements. This provision would not be triggered in the case of an offshore nonqualified deferred compensation arrangement so long as the amounts deferred are not set aside in an offshore trust or similar arrangement.

Some believe that a fund manager's offshore deferred compensation should be treated as an arrangement similar to an offshore trust, even if the arrangement is not technically funded by a trust. Others believe that treatment as an offshore trust is not appropriate merely because the payor of the deferred compensation is a foreign person. Such persons argue that additional factors are necessary for offshore trust treatment, such as whether the creditors of the offshore fund are effectively shielded from access to the fund's assets in the event of default or whether the creditors of the fund are limited primarily to the fund's investors.