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A Silver Lining in the Legislative Cloud Over Private Investment Funds: Proposed Legislation Would Modify the Unrelated Business Taxable Income Rules for Tax-Exempt Investors

Over the past several months, private investment funds (including private equity, venture capital and hedge funds) and their managers have been under intense scrutiny by Congress and the media. Although their main focus has been the taxation of "carried interests" earned by investment fund managers, other aspects of investment fund operations have also been under review, including the use of offshore "blocker corporations" by tax-exempt investors in these funds. Rep. Sander Levin proposed legislation on September 7, 2007 that would ostensibly eliminate the need for such tax-exempt investors to use such offshore blocker corporations.

Background

Under current law, tax-exempt organizations generally are exempt from U.S. federal income taxation. Nonetheless, most are taxed on their "unrelated business taxable income" (UBTI). Although income and gains from securities generally are excluded from UBTI and therefore are not subject to income tax, all or a portion of income and gains from securities *acquired (or treated as having been acquired) with indebtedness* are considered to be "unrelated debt financed income" (UDFI). UDFI is a subset of UBTI, and tax-exempt organizations generally are subject to tax on income and gains that constitute UDFI.

As a result, if a tax-exempt organization were to acquire securities using debt, all or a portion of the organization's income and gains from those securities would be subject to taxation as UDFI. These rules apply regardless of whether the tax-exempt organization holds the debt-financed securities directly, or indirectly, such as through a partnership that acquires the securities with debt.

For some types of investment funds, such as hedge funds, the use of debt is a core strategy to enhance overall investment returns. As a result, a tax-exempt investor's share of such investment fund's income and gains generally would be subject to tax under the UDFI rules.

To eliminate the UDFI consequences arising from their debt-financed investment activities, these investment funds typically use an arrangement under which (a) tax-exempt investors hold stock in a non-U.S. corporation (commonly referred to as an offshore blocker corporation or feeder corporation) and (b) the non-U.S. corporation holds an interest in the investment fund. Under general tax principles, the non-U.S. corporation generally will not be subject to U.S federal income taxation on its share of the gain from the sale of the securities by the underlying investment fund (although it may be subject to U.S. federal withholding tax on its share of certain dividends and interest income). If the non-U.S. corporation is formed in a zero-or no-tax jurisdiction, it will pay little, if any, income tax on its earnings.

Accordingly, the non-U.S. corporation can distribute its earnings from the underlying investment fund to its investors (i.e., the tax-exempt investors) without any material entity-level tax. Furthermore, amounts received by tax-exempt investors from the non-U.S. corporation generally would not be UBTI, and therefore not subject to U.S. federal income tax.

Proposed Legislation.

The proposed legislation excludes from UDFI certain income and gains realized from securities that are debt-financed. While the exclusion applies to all categories of tax-exempt organizations, it only applies to debt-financed income and gains realized by a tax-exempt limited partner of a partnership. Accordingly, the bill is not a complete repeal of the UDFI rules, since a tax-exempt organization would still be subject to tax on income and gains from debt-financed investments held directly by such tax-exempt organization.

Also, the proposed exclusion from UDFI for income and gains earned by a tax-exempt organization from its interest in a partnership is limited to certain asset classes and subject to certain technical requirements. The bill applies only to income and gains from "qualified securities and commodities." This definition includes equity and debt securities of a corporation, but might not apply to interests in partnerships and other asset classes such as oil and gas, timber and real estate. Similar to the current law providing for a limited exception for leveraged real estate held by a partnership, the exception in the proposed legislation also requires the allocation provisions of the partnership agreement to satisfy certain technical requirements referred to as the "fractions rule."

In addition, the bill provides relief for indebtedness incurred by tiered partnerships, which presumably would include interests in investment funds held by funds of funds. The exact application of the rules in these circumstances is vague, however, and will likely require further guidance.

As proposed, the bill would be effective on a prospective basis, to tax years beginning after the date of enactment.

Implications

Given the current political climate, there has been considerable concern within the private investment fund community that Congress would take a different approach towards the use of offshore corporate structures by tax-exempt investors and treat income realized from such structures as UBTI.

The approach taken in the proposed legislation, however, reflects the practical and sensible view that application of the existing UDFI rules to debt-financed investments held indirectly through a partnership is beyond the original intent of the UDFI rules, and reflects a move towards leveling the playing field instead of rewarding only the well-advised. We believe Congress is hopeful that eliminating tax-exempt investors' need for offshore blocker corporations will discourage the use of mechanisms to defer incentive fees in such offshore blocker corporations by hedge fund managers. Additional legislation, however, may address that issue directly.

Given the current controversy over the taxation of private investment funds and their managers, it is impossible to predict whether this bill will ultimately be enacted or, if it is, what other provisions, potentially unfavorable, relating to private investment funds may also be adopted.

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