



ISSUE PAPER

UBIT Exemption for Hedge Fund Investment Income

Position: The Council supports changing the tax code to create an exception to the debt-finance income rules to allow all tax-exempt entities to invest in hedge funds and similar investment partnerships without being subject to unrelated business income tax (UBIT).

U.S. House of Representatives

Sponsor:

Sander M. Levin (D-MI)

Cosponsors: 3

Representative John Lewis (D-GA)
Representative Chris Van Hollen (D-MD)
Representative Jim McDermott (D-WA)

U.S. Senate

There is no Senate companion UBIT bill

Revenue Estimate

A loss of \$100 million federal tax revenue annually

Background

Both private foundations and public charities, such as community foundations, are subject to an unrelated business income tax (UBIT) on investment income if the foundation incurred debt to make the investment. Originally, the UBIT was enacted as a measure to prevent certain clearly abusive transactions in which businesses used sham transactions with charitable entities to convert ordinary income into capital gains. The debt-financed property rules now have the unintended consequence of burdening foundations that invest in partnerships, such as hedge funds and similar entities that pay no tax at the entity level but rather pass through their income and expenses to their investors. If the partnership incurs debt in the course of its investment activity, that debt is passed through to the investors, triggering the application of UBIT to the foundation's investment income.

Proposal

Representatives Sander M. Levin (D-MI), Jim McDermott (D-WA), and Chris Van Hollen (D-MD) have introduced Unrelated Business Income Tax (UBIT) legislation in the House. H.R. 3497 would amend the Internal Revenue Code of 1986 to allow tax-exempt entities to invest directly in hedge funds without being subject to unrelated business income tax (UBIT). The exception is modeled on the current exception to these rules for pension funds and universities from UBIT when they invest in debt-financed real estate. However, this proposed new exception would be available to all tax-exempt entities, including foundations. H.R. 3497 would encourage tax-exempts to invest directly in U.S.-based hedge funds, rather than routing investments offshore. The Senate has not yet introduced a companion bill to H.R. 3497.

Rationale

Charities, like all investors, seek to maximize their investment returns and stay competitive with investment performance benchmarks all while minimizing risk. Hedge funds have proven to be an effective tool to reduce volatility and risk while producing positive returns under all market conditions. The tax imposed on nonprofits under the UBI rules necessarily reduces those returns. To avoid that result, many foundations invest in hedge funds through off-shore "blocker" corporations in jurisdictions with little or no corporate income tax. Several IRS rulings provide that the interposition of the corporate entity blocks the attribution of the partnership debt to the foundation investor. In response to concerns raised during a Congressional hearing about the prevalence of such practices, several witnesses recommended creating an exception to the debt financed income rules to allow all tax-exempt entities to invest directly in onshore hedge funds without being subject to UBIT, eliminating the need to route such investments off-shore.

Opposition

The provision is estimated to result in a revenue loss of \$100 million per year. There's no clear projection of what the economic value of bringing such investments back on-shore would be.

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