

New York University
National Center on Philanthropy and the Law

Legal Framework: Global Investing
November 7, 2003

Selected U.S. Tax Aspects of International Investment by U.S. Charitable Organizations

Stephen E. Shay¹
Boston, Massachusetts

I. Introduction.

A. “What do they mean we are not exempt?”

1. A U.S. international tax practitioner consulted by a tax-exempt charitable client new to international investment often will hear this question when (foreign) withholding tax is imposed on dividend income from a foreign issuer.
2. No, Virginia, tax laws and tax-exemption are jurisdictionally limited.²

¹ Partner, Ropes & Gray LLP. The views expressed are those of the author and do not represent the views of Ropes & Gray LLP or its clients. The author thanks his colleagues Daniel Kolb and Kendi Ozmon for comments on an earlier draft of this paper.

² Although tax exemption for charities derives from the law of each taxing jurisdiction, U.S. tax exemption under Section 501(c)(3) of the Code is not limited to U.S. entities. Thus, a foreign entity that obtains an opinion of counsel that it satisfies the criteria of Section 501(c)(3) may claim exemption from U.S. withholding tax. Treas. Reg. § 1.1441-9. In the author's experience, most other countries do not follow the U.S. approach of unilaterally granting exemption to foreign entities. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or regulations thereunder.

- B. This paper considers selected aspects of the taxation of U.S. charitable organizations' cross-border investment and business activity and whether U.S. rules for exemption or taxation of this income favors or discourages this investment. The paper considers on a preliminary basis possible tax law changes affecting charitable organizations' international investment.
- C. Background Observations.
1. Where they apply, foreign withholding taxes disadvantage U.S. charitable organizations' cross-border portfolio investment in relation to comparable domestic portfolio investment. For purposes of this discussion, "portfolio" investment refers to debt or equity investments in an issuer in which the charity owns less than 10% of the voting power and value.
 - (i) U.S. charitable organizations generally are not treated as exempt from income taxation by other countries.
 - (ii) Most dividends on foreign portfolio equities are subject to shareholder-level taxation by the source country, generally in addition to the applicable foreign corporate-level tax.³
 - (iii) Most interest on foreign portfolio fixed income instruments is free of withholding tax at source. Many countries provide for exemption from withholding tax on interest from certain categories of fixed income investments, generally including publicly issued debt. Interest on non-traded debt often is subject to foreign withholding tax (subject to exemption by treaty, discussed below).

³ The United Kingdom and India not impose withholding tax on dividends. Australia and New Zealand do not impose withholding tax on dividends that have been borne a full tax at the corporate level.

- (iv) U.S. bilateral income tax treaties generally cover a tax-exempt charitable organization and reduce the level of foreign withholding taxation to the same level as applies to a taxable U.S. person.
 - a. Most, but not all, U.S. treaties provide reciprocal exemption of interest.
 - b. All U.S. treaties permit withholding tax on portfolio dividends as a general matter. As noted below, a few treaties provide reciprocal exemptions for dividends paid to charitable organizations.
 - c. As discussed below, certain U.S. income tax treaties provide reciprocal exemption on portfolio income of charitable organizations that are tax-exempt in their home country (the “residence country”) and satisfy criteria for exemption in the source country.
- (v) Although self-help measures may be used to avoid remaining withholding taxes (on dividends and limited categories of interest), they involve transactions costs and therefore mitigate but do not eliminate the tax inefficiency.
- (vi) The United States does not allow a refundable credit for foreign taxes paid on income exempt from U.S. taxation (a credit for foreign taxes is allowed against U.S. tax on unrelated business income).
- (vii) The actual amount of source country withholding tax on charities’ foreign portfolio investments likely is modest. This

assertion, however, should be the subject of empirical research.

2. International unrelated business activity carried on through a foreign corporation often is encouraged by current U.S. international taxation rules.
 - (i) It generally is possible to achieve low or zero rates of foreign taxation, and to avoid U.S. taxation of, unrelated business taxable income (“UBTI”) earned through a foreign corporation.
 - (ii) A dividend from a foreign business entity classified for U.S. tax purposes as a corporation is exempt to the same extent as a dividend from a domestic corporation, irrespective of the level of foreign tax imposed on income from the underlying earnings or the dividend. Moreover, the U.S. exemption applies to a dividend irrespective of whether the corporate income would be related or unrelated business income if earned directly by the U.S. charitable shareholder.
 - (iii) Whether a U.S. tax-exempt’s foreign investment is more heavily taxed than a comparable domestic investment depends on the level of source country taxation.

D. Proposals for Consideration.

1. Increase the number of U.S. treaties providing for reciprocal exemption from withholding taxes on income from charities’ portfolio investments.

2. Seek OECD Fiscal Committee consensus on a definition of charitable for this purpose and seek multilateral agreement to reciprocal exemption of portfolio income.
3. Impose U.S. unrelated business tax on income earned through a foreign corporation 10% or more owned by the U.S. charity to the extent that the income has not borne foreign tax at an effective rate equal to the top U.S. corporate tax rate (using a mechanism similar to that used in Section 1248(b) of the Code). Apply the principles of Section 512(b)(13) to treat interest received from a 10% or more owned foreign corporation as UBTI to the extent the interest is allowable to income that would be UBTI in the hands of the U.S. charity.

II. U.S. Taxation of Charitable Organizations.

A. Eligibility for Tax-Exempt Status.

1. An organization described in Section 501(c)(3) generally is exempt from income taxation.
2. The key elements for tax exemption are that the organization be “organized and operated exclusively” for one or more of the enumerated charitable purposes, including “religious, charitable, scientific, ... , literary or educational” purposes.⁴
3. The criteria for exemption do not foreclose carrying on a business, whether related or unrelated to the organization’s exempt purpose, so long as it is in furtherance of the organization’s exempt purpose.⁵

⁴ I.R.C. § 501(c)(3).

⁵ Treas. Reg. § 1.501(c)(3)-1(e)(1); Rev. Rul. 64-182, 1964-1 C.B. 186.

4. A foreign entity that satisfies the criteria for exemption under Section 501(c)(3) may be exempt from U.S. taxation on U.S. income other than unrelated business taxable income.⁶

B. Tax Exemption and the Unrelated Business Income Tax ("UBIT").

1. An otherwise exempt charitable organization must pay tax on its UBTI at the applicable corporate income tax rate unless it is a charitable trust in which case trust tax rates apply.⁷
2. UBTI generally includes income from regularly carrying on a trade or business not substantially related to the organization's exempt purpose.⁸
3. Interest, dividends, payments with respect to securities loans, commitment fees, income from notional principal contracts, certain rents from real property and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, are *excluded* from UBTI (unless they are from debt-financed property).⁹
4. UBTI includes income from debt-financed property,¹⁰ including debt-financed portfolio investments.¹¹ Investment income is UBTI to the extent that the organization incurred indebtedness to acquire or improve the property generating the income or gains.¹² Interest and royalties from controlled entities also are UBTI to the extent the

⁶ A foreign entity cannot receive deductible charitable contributions directly from the taxpayer.

⁷ I.R.C. § 511(a)(1), (b)(1).

⁸ I.R.C. § 513(a).

⁹ I.R.C. § 512(b)(1); Treas. Reg. § 1.512(b)-1(a)(1).

¹⁰ I.R.C. § 514(a); exceptions from UBTI are found at §512(b)(1)(A) – (D).

¹¹ Exceptions from debt-financed treatment apply to short sales of stock, Rev. Rul. 95-8, 1995-1 C.B. ____, and income from qualifying securities loans, I.R.C. § 512(a)(5).

¹² I.R.C. §§ 512(b)(4), 514.

deduction is allocable to UBTI of the payer.¹³ For this purpose, control means 50% ownership by vote or value.

5. A foreign exempt organization only is taxed on UBTI that is effectively connected with a U.S. business (“ECI”) and U.S.-source income that is not ECI.¹⁴

C. Special Rules Applicable to Private Foundations and Charitable Remainder Trusts.

1. Private Foundations.

- (i) Under the Code, public charities are “carved out” from the presumption that a charitable organization is a private foundation. Thus, very generally, a private foundation is a charitable organization, other than a religious organization, educational institution, hospital or governmental entity, or a supporting organization for a public charity, that receives one-third or less of its support from the public (as defined).¹⁵
- (ii) A domestic private foundation is subject to various special rules and excise taxes, including an excise tax on its net investment income of from 1% - 2%.¹⁶ A foreign private foundation is subject to a 4% excise tax on its U.S.-source gross investment income.¹⁷

2. Charitable Remainder Trust (“CRT”).

¹³ I.R.C. § 512(b)(13).

¹⁴ I.R.C. § 512(a)(2).

¹⁵ See generally, I.R.C. § 509(a).

¹⁶ See generally I.R.C. §§ 4940 - 4945.

¹⁷ I.R.C. § 4948.

- (i) Charitable remainder trusts come in several varieties, but all are irrevocable trusts with a remainder interest for the benefit of a charity.¹⁸ A CRT is subject to the private foundation rules.
- (ii) A CRT is exempt from tax, but loses its tax exemption if it receives *any* UBTI.¹⁹

D. U.S. Income Tax Treaties.

1. General. The U.S. model income tax treaty does not provide special substantive taxing rules for charitable organizations, but does provide that "a legal person organized under the laws of a Contracting State" that is "generally exempt from tax in that State" and is established and maintained in that State "exclusively for a religious, charitable, educational, scientific or other similar purpose," will be treated as a resident of that state for purposes of the treaty.²⁰ This definition clarifies a possible ambiguity under the OECD model treaty definition of residence, which requires that a resident be "liable to tax" in its country of residence.²¹
2. Special Treaty Rules. Treaties with Canada, Germany, Mexico and the Netherlands include articles dealing specifically with charitable organizations. In general, these articles exempt the organization from tax by the other country on non-business income if the charity meets

¹⁸ See I.R.C. 664; Carolyn M. Osteen and Martin Hall, Tax Aspects of Charitable Giving 273 - 334 (2d ed. 2000).

¹⁹ I.R.C. 664(c). A legislative proposal in H.R. 7 would change this to a 100% excise tax.

²⁰ United States Model Income Tax Convention, Sept. 20, 1996, art. 4(1)(b), 1 Tax Treaties (CCH) ¶ 214.04 (hereinafter U.S. Model Treaty).

²¹ See Organization for Economic Co-Operation and Development, Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, art. 4 (2000) (hereinafter OECD Model Treaty); American Law Institute, Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties, 142 (1992) (hereinafter ALI, Income Tax Treaties) .

the substantive standards for exemption under the laws of both countries.²² Key elements of these rules are:

- (i) The scope of entities covered is limited to entities that are described in Section 501(c)(3).
- (ii) The income that is exempt includes income that would be exempt in the charity's country of residence and, in the case of the U.S. - Canada treaty, cannot be from a related person other than another entity that would be exempt under the treaty provision.²³ Subject to a reciprocity condition, these provisions would exempt program revenue as well as investment income.
- (iii) In practice, a requirement that a charity be exempt in the source country as well as in its home country can be an impediment to use of the treaty if it requires implementation by competent authority action. A protocol to the U.S. treaty with Germany provides that procedures will be developed to implement the charitable organization article, but no procedures have been issued and the article is little used.
- (iv) In addition, the treaties with Mexico and the Netherlands require that the charity satisfy the limitations on benefits article. Thus, under the Netherlands treaty, more than 50% of the "beneficiaries, members or participants, if any," in a U.S. charity must be "qualified persons" eligible for treaty benefits.²⁴

²² See Peter Blessing, *Income Tax Treaties of the United States* ¶21.01 (1998).

²³ U.S. - Canada Income Tax Convention, art. XXI(3), 1 Tax Treaties (CCH) ¶ 1901.21.

²⁴ U.S. - Netherlands Income Tax Convention, art. 26(1)(e), 3 Tax Treaties (CCH) ¶ 6103.28.

III. Normative Bases for Tax Exemption and Rationales for the UBIT.

- A. Although U.S. tax exemption for charitable organizations dates back to the earliest U.S. federal income tax, and far earlier in other countries, the normative basis for income tax exemption is surprisingly unclear. The theories relating to exemption include:
1. Exemption is a subsidy for relieving government of burdens it otherwise would have to provide (the “subsidy theory”);²⁵
 2. Exemption supports a pluralistic nonprofit “third sector” (to balance the for-profit and governmental sectors of society) (the “community benefit theory”);²⁶
 3. Exemption is appropriate because of the difficulty inherent in measuring the income of a nonprofit (the “income measurement theory”);²⁷
 4. Exemption redresses the increased cost of capital that arises from the inability of a nonprofit to distribute returns to its members (the “capital formation theory”);²⁸
 5. Exemption is justified because of the benefits to consumers of nonprofit services and larger social benefits (the “altruism theory”);²⁹

²⁵ H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 – 20 (1938); but see Harvey P. Dale, *Foreign Charities*, 48 *Tax Law*. 655, 660 – 662 (1995).

²⁶ John D. Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Exemption For Private Educational Institutions)*, 35 *Ariz. L. Rev.* 841, 864-867 (1993).

²⁷ Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *Yale L.J.* 299, 305 - 306 (1976).

²⁸ Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *Yale L.J.* 54 (1981).

²⁹ Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 *B.C. L. Rev.* 501, 610 – 16 (1990); Rob Atkinson, *Nonprofit Symposium: Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 *Stetson L. Rev.* 395 (1997) (evaluating these theories and elaborating slightly on his altruism theory).

6. Exemption is justified for organizations funded substantially (1/3d or more) with donations (the “donative theory”);³⁰ and
7. Exemption compensates for the additional risks that nonprofits take in the absence of market pricing of demand for its goods and services (the “risk compensation theory”).³¹

B. Evaluation of Rationales for Exemption.

1. There does not appear to be a consensus that any one or combination of the preceding theories is superior as a normative basis for tax exemption.
2. The long history of exemption may be the strongest support for the widely-shared layman’s intuition that exemption is appropriate.³²
 - (i) A policy supported solely by a widely-shared intuition, however, is vulnerable if the intuition is based on false premises. The layman’s intuition likely does not take account of the following.
 - a. Although denominated “nonprofits”, charitable organizations may make substantial profits so long as they are devoted eventually to the organization’s exempt purpose.
 - b. Charitable organizations are not required to support the less fortunate. Although data are scarce, there is no

³⁰ Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 Wash. L. Rev. 307, 332-38 (1991); John D. Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 Ariz. L. Rev. 841 (1993).

³¹ Nina J. Crimm, *An explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 Fla. L. Rev. 419 (1998).

³² See Kenneth Liles & Cynthia Blum, *Development of the Federal Law of Charities*, 39 Law & Contemp. Prob. 6 (1975) (exemption first found in the Act of 1984).

evidence that exemption achieves any income redistribution objective.³³ Indeed, it is possible that exemption is regressive.

- c. Nonprofits generally are not transparent and there are relatively few safeguards regarding the governance of a nonprofit.
 - d. Tax exemption is a very indirect subsidy for the claimed benefits of nonprofits and rewards charitable organizations with the greatest surpluses.
- (ii) There is little available data on which to evaluate the revenue loss from exemption.
- a. The tax exemption for charitable organizations is not treated as tax expenditure so there is no government estimate of the revenue loss from exempting charitable organizations' income.³⁴ Outside of the UBTI, there are no rules for determining a charity's income that is exempted.
 - b. The most recent Statistics of Income data from 1999 and shows that Section 501(c)(3) organizations (not including private foundations) had total net revenue (income from gifts, programs and investments less expenses) of \$86 billion.³⁵ The 1999 income of private foundations less expenses and grants paid was \$26

³³ See Charles T. Clofelter (ed.), *Who Benefits From the Nonprofit Sector?* (Univ. of Chicago 1992).

³⁴ Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2004*, 110 (Table 6-3).

³⁵ Paul Arnsberger, "Charities and Other Tax-Exempt Organizations, 1999," *Statistics of Income Bulletin* (Spring, 2002) at 122 (Figure A).

billion.³⁶ If these amounts equated to taxable income and were taxable at 35%, the tax revenue would be \$30 billion and \$9 billion, respectively.

C. Rationales for the UBIT.

1. The original rationale for the UBIT was the need to prevent unfair competition between nonprofit and for-profit businesses³⁷ and to contribute revenue for the Korean War.
2. Professor Rose-Ackerman points out that unfair competition rationale is not supportable in competitive market conditions, but may apply in the context of imperfect competition.³⁸ Professor Hansmann has argued that the UBIT may be supported on economic efficiency grounds.³⁹
3. Even if the economic support for the UBIT is limited, arguably it may be supported on the grounds that perceived parity with for profit firms is necessary to preserve the legitimacy of the income tax in the eyes of for-profit taxpayers.⁴⁰

³⁶ Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," *Statistics of Income Bulletin* (Spring, 2002) at 138 (Figure A).

³⁷ The Supreme Court decision in *Trinidad v. Sagrada Orden De Predicadores*, 263 U.S. 578 (1924) originated what became known as the destination of income test, permitting a nonprofit to carry on an unrelated business so long as the income was used to further exempt purposes. *Roches's Beach v. Commissioner*, 96 F.2d 776 (2d Cir. 1938) held that a corporation owned by a charitable foundation that carried on an unrelated business was entitled to exemption. After universities started to take full advantage of this situation, including New York University's famed acquisitions of the Mueller Spaghetti Company and other operating businesses, Congress enacted the UBIT in 1950. Revenue Act of 1950, ch. 994, 64 Stat. 906.

³⁸ Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 *Stan. L. Rev.* 1017 (1982).

³⁹ Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 *Va. L. Rev.* 605 (1989).

⁴⁰ See Stephen E. Shay, J. Clifton Fleming and Robert J. Peroni, *The David R. Tillinghast Lecture: 'What's Source Got To Do With It?' Source Rules and International Taxation*, 56 *Tax L. Rev.* 81, 111 (2002) (perceived parity in the eyes of resident taxpayers as a justification for source taxation of nonresidents).

4. The rationale for treating debt-financed income from portfolio investments as UBTI is more mysterious. Suzanne Ross McDowell has raised, and criticized, three rationales:
 - (i) It is a means of achieving greater accountability for charities by forcing them to finance activities with public support.
 - (ii) It forces the exempt to focus on passive investing rather than the conduct of active businesses.
 - (iii) It is an anti-abuse measure to prevent shifting of the benefit of the exemption to non-exempt taxpayers.⁴¹

5. [Data on revenue from UBIT.]

IV. Foreign Portfolio Equity Investment by U.S. Charitable Organizations.

A. Reasons for Investment in Foreign Portfolio Equities.

1. There is debate regarding the degree to which international equity investment diversifies investment risk.⁴² Nonetheless, international equities are routinely recommended as a component of a diversified securities portfolio.

2. Although the IRS does not publish data regarding the international component of charities' portfolios, anecdotal experience suggests that it has increased over the past decade. While the Asian currency crises in 1997/1998 and the 9/11 tragedy were shocks to global markets that caused retrenchments from international investments, the effects of these shocks appear in each case to have a limited duration.

⁴¹ Suzanne Ross McDowell, *Taxing Leveraged Investments of Charitable Organizations: What Is The Rationale?*, 39 Case W. L. Rev. 705 (1988/1989).

⁴² [Discussion of this finance literature to come.]

- B. Taxation of U.S. Charities' Direct Holdings of Foreign Portfolio Equity Investments (Not Debt-Financed).
1. Source country taxation of capital gains and dividends.
 - (i) Most countries do not tax foreign investors on gains on the sales of publicly-traded stocks.
 - (ii) It is customary, however, for countries to impose withholding tax on dividends.
 - (iii) Income classification problems can arise. For example, Canada treats as a dividend (potentially subject to withholding tax) a redemption distribution that for U.S. tax purposes would be taxable as a capital gain.⁴³
 2. Treaties. As discussed above, current U.S. treaty practice is to provide explicitly that a charitable organization may be a treaty resident and eligible for treaty benefits.
 - (i) Most but not all U.S. treaties limit taxation of gains to the residence country, other than gains from the sale of a real property interest or attributable to a business in the source country. In some cases, such as in treaties with Spain and Thailand, the source country retains the right to tax capital gains on the sale of shares.
 - (ii) U.S. treaties generally reduce the rate of withholding tax on portfolio dividends to 15%. Treaties with Canada, Germany,

⁴³ A number of years ago, a hedge fund with tax exempt partners made an non-debt financed arbitrage investment in shares of a Canadian issuer about to tender for a portion of its own shares at a higher tender price, only to find that an unexpected 15% Canadian withholding exceeded the anticipated gain. The availability of exemption from withholding for charities in the U.S. - Canada income tax treaty saved some embarrassment. During the remainder of the same tax year, substantial attention was given to generating sufficient foreign source passive income to permit taxable investors to credit the excess withholding tax.

Mexico and The Netherlands provide that a charitable organization may be exempt from dividend withholding. The new U.S. treaty with the United Kingdom provides exemption for dividends paid to pension funds, but not charities.

3. Practice.

- (i) A withholding tax on dividends is not necessarily a barrier to investment. If a dividend yield is 3% (which in recent years would be very high), a 30% non-creditable withholding tax reduces the overall return by 90 basis points, a 15% withholding tax would cost 45 basis points. These costs likely would not deter making an otherwise promising equity investment.
- (ii) Self-help measures to avoid dividend withholding tax.
 - a. Investments may be skewed to non-dividend paying stocks that do not suffer this cost.
 - b. It is possible to avoid dividend withholding by trading the shares around the dividend record date to investors that can utilize the withholding taxes as credits.⁴⁴
 - c. It is possible to construct a notional principal contract to obtain the economics of an equity holding (but not the shareholder rights) without suffering the withholding tax.⁴⁵ The gains and notional principal

⁴⁴ See, e.g., *IES Industries, Inc. v. U.S.*, 253 F.3d 350 (8th Cir. 2001) (foreign tax credit allowed to purchaser-reseller of stock in dividend trading scheme); *Compaq Computer v. U.S.*, 277 F.3d 778 (5th Cir. 2001) (same). I understand that trading around dividend dates is a significant factor in the REIT market.

⁴⁵ [Greg May Tax Notes article.]

contract income from these strategies generally is excluded from UBTI.⁴⁶

- d. The transaction costs of withholding tax avoidance strategies, however, limit their utility to holdings of a sufficient size to support and warrant the burdens. Moreover, in certain circumstances, taxpayers may not be able to avoid the withholding. Certain index fund products, for example, might not permit such trading of component securities.

C. Possible Proposals to Achieve Neutral Tax Treatment of Foreign Portfolio Equity Investment.

1. Refundable credit for foreign withholding tax.

- (i) One way to achieve neutral shareholder-level tax treatment of cross-border equity investment by a U.S. charitable organization that is tax-exempt on dividends and gains would be for the United States to unilaterally refund the source tax on dividends or gains.
- (ii) While this would achieve neutrality in shareholder-level taxation of the charitable organization, the United States would be subsidizing the foreign tax cost of the investment.
 - a. It would seem unlikely that the benefit of reduced investment risk from the diversification of the charitable organization's portfolio is greater than the cost of the foreign tax. The available investment

⁴⁶ Treas. Reg. § 1.512(b)-1(a).

substitutes include both U.S. portfolio investments and non-U.S. investments not subject to withholding tax.

- b. The normative rationales for tax exemption described above would not require that the United States bear the revenue cost of exemption from foreign tax.

2. Reciprocal Treaty Exemptions.

- (i) An alternative bilateral approach would be to reform the current U.S. treaty policy to make a greater effort to adopt workable treaty-based exemption of charitable organization's investment income.
 - a. The charitable entities eligible for exemption should continue to be limited to those established and maintained exclusively for a religious, charitable, educational, scientific or other similar purpose. The determination should be under the standards applied under the law of the residence country only.
 - b. The income subject to exemption on a routine basis should be portfolio investment income only. This would take pressure off of the need to make qualification subject to the standards of both countries.
- (ii) Reciprocal treaty exemption of investment income would achieve cross-border tax neutrality for the investment income of a qualifying charity from investments in a treaty partner country without the revenue cost of unilateral implementation of a refundable credit.

3. Seek OECD Consensus on Definition of Charitable Entity To Be Eligible for Treaty Exemption of Investment and Program Income.
 - (i) The U.S. should ask the OECD Committee on Fiscal Affairs to consider adopting reciprocal exemption of charitable entities on investment and program income in the OECD Model Treaty.
 - (ii) A key aspect of the project would be to agree on a common definition of charitable organization that would be eligible for the treaty relief. As papers from last year's conference indicate, common law countries share the same heritage of English charitable law, but civil law countries tend to place more reliance on government action to achieve social goals.
 - (iii) If there is agreement on the definition of "charitable," it might be possible to expand the scope of exemption to cover program revenue as well as investment income.
 - (iv) The OECD is the best multilateral forum for achieving consensus on tax issues such as these. U.S. treaty negotiations are facilitated if the U.S. position corresponds to an OECD position (followed by most developed countries and many developing countries).

V. Debt-Financed Investment in Portfolio Securities – Use of Foreign Blockers.

A. Reasons for Debt-Financed Investment Strategies.

1. Use of debt-financing to enhance portfolio returns, at greater risk, has become a staple of modern investment.

2. Hedge fund investment strategies often involve debt-financed investments that would give rise to UBTI.
 3. It has become commonplace for sophisticated tax-exempt investors to establish foreign corporations to participate in investments, such as investments in hedge funds, that involve use of debt financing. The objective of such a structure typically is to transform UBTI from debt-financed income into unleveraged and therefore exempt dividend income. A diagram of a blocker structure is attached at Appendix A.
 4. Generally, it does not matter whether the foreign corporation acquires U.S. or foreign securities. If the foreign corporation borrows to purchase U.S. securities, tax-exempt shareholders will not be directly affected (though see discussion of U.S. tax risks below).
- B. U.S. Tax Issues Raised by Use of a Foreign Blocker.
1. If the foreign corporation is a controlled foreign corporation (“CFC”), U.S. tax-exempt shareholders have, since the adoption of Section 512(b)(17) in 1996, taken comfort from the language and legislative history of that section that Subpart F inclusions (other than of insurance income) do not give rise to UBTI.
 2. If the foreign corporation is not a CFC, it generally will be a passive foreign investment company. Treasury regulations, however, have clarified that a tax-exempt entity generally will not be adversely affected.

3. The anti-abuse provision of section 269 generally is not thought to apply.⁴⁷
4. Perhaps the most substantial downside risk is that the foreign corporation will be found to be carrying on a U.S. trade or business. The risk is a combined corporate level tax at 35% and a 30% branch tax for an effective rate of up to 54.5%. While a series of issues must be addressed, the risks are deemed remote and practice is to go forward and to manage operations to avoid or minimize those risks.⁴⁸
5. Foreign blocker corporations are used routinely to hold U.S. as well as foreign debt-financed investments.

C. Policy considerations.

1. Although it is unclear why the debt-financed rules should apply to margin or similar financing of portfolio stockholdings, use of foreign blockers to avoid debt-financed income clearly is an end-run around the debt-financed investment rules.
2. In the case of a CRT, the IRS has blessed the use of a foreign blocker - which has not gone unnoticed in the tax-exempt world.⁴⁹
3. If use of a foreign blocker generally is equally effective to make debt-financed investments in U.S. as well as foreign portfolio fixed income and equity securities, it does not distort the investment choice.
4. The more important issue to be decided is whether the debt-financed rules should apply to portfolio securities investments. The distinction

⁴⁷ See Sam Siegal, 45 TC 566, *acq.*, 1966-2 C.B. 7.

⁴⁸ See David Sicular, Selected Current ECI Issues for Investment Funds (paper on file with the author); see also. Stuart LeBlang and Rebecca Rosenberg, Toward an Active Finance Standard for Inbound Lenders, ___ Tax Mgmt. Int'l J. ___ ((2002).

⁴⁹ See e.g., Private Ruling 2001 15032 (Jan. 14, 2003).

today between diversifying investments through use of securities loans (not UBTI under Section 512(a)(12)) and repurchase agreement financing (which gives rise to UBTI) is difficult to support.

- VI. Charitable Organizations' Direct Investment through Foreign Corporations.
 - A. Investment Objectives
 - 1. Diversification beyond stocks and bonds: alternative asset classes, geographic dispersion and different currency environments.
 - 2. Direct investments can take advantage of inefficient pricing in non-public markets, special management abilities and other opportunities.
 - B. U.S. Tax Objectives.
 - 1. Minimize foreign tax, because the taxes are not creditable against exempt income.
 - 2. Avoid UBTI.
 - C. U.S. Taxation of Controlling Interests:
 - 1. Example 1: A U.S. tax-exempt charitable organization ("TE") owns 100% of a foreign corporation ("FC") directly (see Diagram 1 at Appendix B). FC is a resident of and carries on business in Country X. Country X has a corporate tax rate of 30% and does not withhold tax on dividends.
 - (i) A dividend from FC to TE is not UBTI.
 - (ii) The after-tax return to TE from the investment is based on the level of the foreign country tax.

2. Example 2: Assume the same facts as in Example 1, but TE capitalizes FC with debt to reduce foreign tax. (See Diagram 2 at Appendix B.)
- (i) Interest generally is excluded from UBTI, but Section 512(b)(13) treats interest as UBTI to the extent the interest deduction attributable to UBTI.
 - (ii) There is a substantial question whether Section 512(b)(13) applies to interest allocable to non-ECI foreign income. Under section 882, except where the context clearly indicates otherwise, gross income of a foreign corporation includes only U.S.-source non-ECI and ECI from any source.⁵⁰
 - a. The regulations are to the same effect, but do not contain the language “except where the context clearly indicates otherwise”.⁵¹
 - b. A foreign tax -exempt organization only can have unrelated business income that is either U.S.-source non-ECI or ECI.⁵² This is further support for an interpretation that Section 512(b)(13) does not apply to interest allocable to non-ECI foreign income.
3. Example 3 -- structuring to avoid the possibility of Section 512(b)(13): TE owns FC1 and FC3. FC1 owns FC2, which is an operating company. FC3 makes loans to FC2, which is either a local law company (if consolidation with FC1 is possible) or a local law partnership, each classified as a “C” corporation for U.S. tax

⁵⁰ I.R.C. § 882(b).

⁵¹ Treas. Reg. § 1.882-3.

⁵² I.R.C. §512(a)(2).

purposes. FC1 and FC3 elect to be disregarded. (See Diagram 3 at Appendix B.)

- (i) Because both FC1 and FC2 are disregarded, the loan is disregarded for U.S. tax purposes.
- (ii) Variations on this planning may be used to avoid 512(b)(13) with respect to other payments (to the extent it may be applicable to foreign, non-ECI income).

4. Summary: The UBTI is eminently avoidable with respect to foreign direct investments.

D. Tax Neutrality In Relation to Foreign Direct Investment through a Foreign Corporation.

1. Structural Issues: Taxation of a Foreign Corporation.

- (i) The United States does not impose a corporate-level tax on foreign non-ECI income earned by a foreign corporation. Nonetheless, a dividend received by a U.S. charitable organization with respect to non-debt-financed stock of a foreign corporation is treated as exempt, irrespective of what level of foreign tax is paid.
 - a. Example 4: Tax-exempt organization (“TE”) owns 100% of a domestic corporation (“DC”) that carries on business A in the United States. DC pays a 35% Federal corporate tax. TE’s dividends from DC are exempt from tax.
 - b. Example 5: TE owns 100% of a foreign corporation (“FC”) that carries on business A outside the United

States in Country X. Assume alternatively that the Country X corporate tax is 12.5% (the Irish corporate tax rate) or 45% (which approximates the combined German corporate and trade tax rates). In both cases, TE's dividends from FC are exempt from tax.

- (ii) In Example 4, U.S. business earnings bear an aggregate tax burden of 35%. In Example 5, foreign business earnings bear an aggregate rate of either 12.5% or 45%.

2. Possible Proposals to Achieve Neutral Taxation of Foreign Direct Investment through a Foreign Corporation.

- (i) Excess foreign taxes. If tax neutrality is the objective, the only practical option (which is unrealistic from a political perspective) is a unilateral refundable credit for the excess tax. Treaty relief generally is not available for corporate-level taxes.
 - a. The normative rationales for tax exemption described above do not require that the United States bear the revenue cost of causing foreign direct investment to be tax neutral to a tax-exempt U.S. charitable organization.
 - b. Indeed, given the lack of certainty regarding the incidence of the corporate tax, it is not clear who bears the burden of the higher foreign tax.
- (ii) Low foreign taxes. Where the effective rate of foreign tax is less than the U.S. rate, there would be a tax incentive for a U.S. tax-exempt to shift funds to direct foreign investment in

lieu of a comparably risky (on a pre-tax basis) U.S. investment. While the rationale for application of the UBIT may be weak or uncertain in the domestic context, there would seem to be no reason to encourage marginal investment of tax-exempts' funds in foreign as opposed to U.S. investments where a low foreign tax rate may be achieved (which is often).

- a. A logical alternative would be (i) to impose U.S. unrelated business tax on income earned through a 10% or more owned foreign corporation (when received by the charitable organization) to the extent that the income has not borne foreign tax at an effective rate equal to the top U.S. corporate tax rate (using a mechanism similar to that used in Section 1248(b) of the Code) and (ii) apply the principles of Section 512(b)(13) to treat interest received from a 10% or more owned foreign corporation as UBTI to the extent the interest is allowable to income that would be UBTI in the hands of the U.S. charity if it were U.S. income.
- b. The 10% ownership threshold is the same as for Section 902 indirect foreign tax credits where it also is necessary to determine corporate-level earnings and profits for U.S. tax purposes. (There would seem to be no need to adopt the current controlled foreign corporation rule that 10% U.S. shareholders in the aggregate must own over 50% of the foreign corporation.)

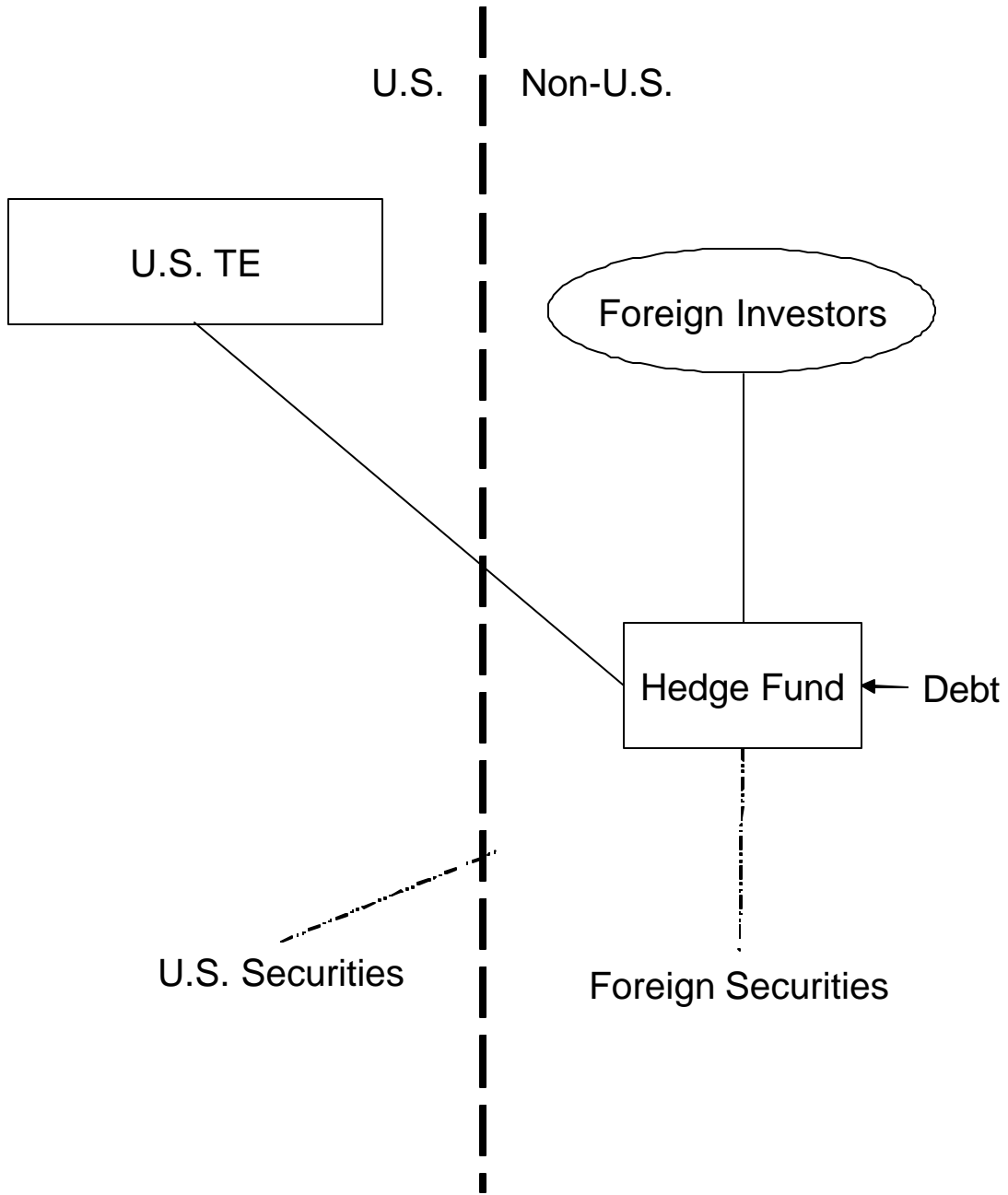
- (iii) This proposal would achieve neutrality in the low-tax case and preserve tax competition in the high-foreign tax case.

VII. Conclusions.

The taxation of U.S. charitable organizations' foreign portfolio income (ownership of less than 10% interests in the issuer) is adversely affected by foreign withholding taxes. U.S. treaty policy should support reciprocal exemption of this income.

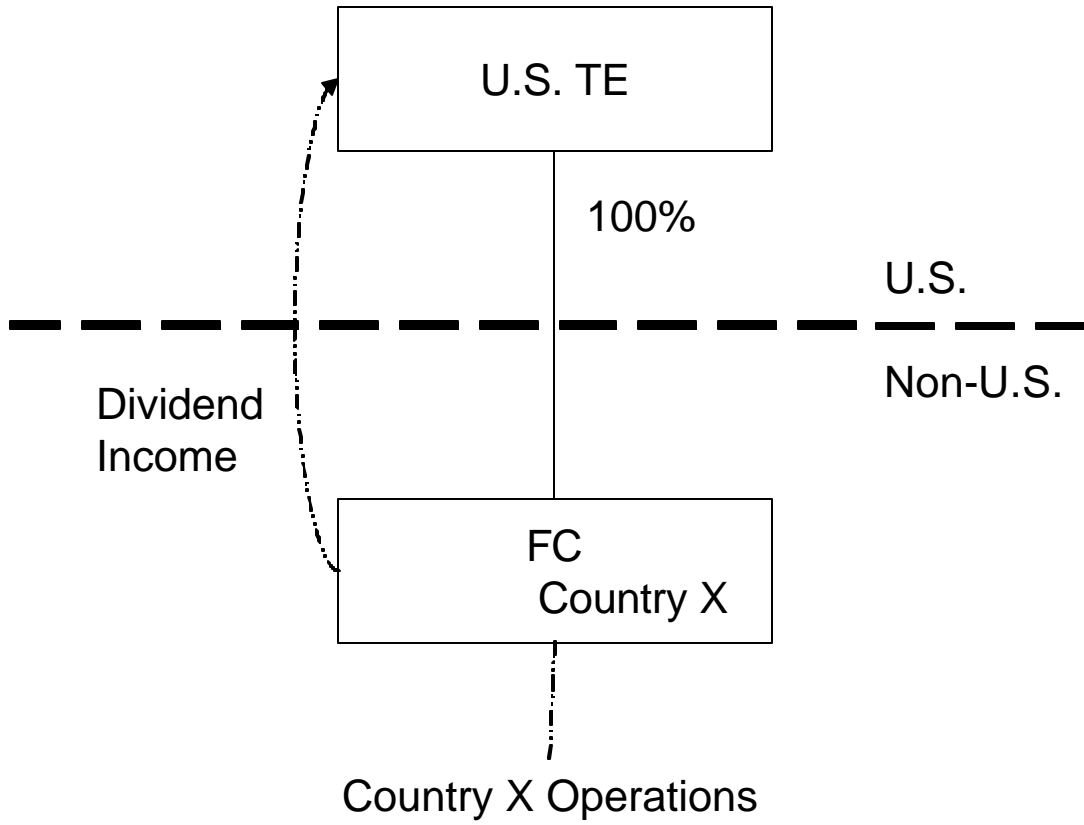
U.S. taxation of charitable organizations' foreign business income earned through a substantial (e.g. greater than 10% interest in a foreign corporation) is particularly favorable in relation to a comparable U.S. investment. The UBIT should be applied in a manner that would neutralize the incentive provided by low-foreign taxes to U.S. charities to locate direct investment abroad.

Appendix A



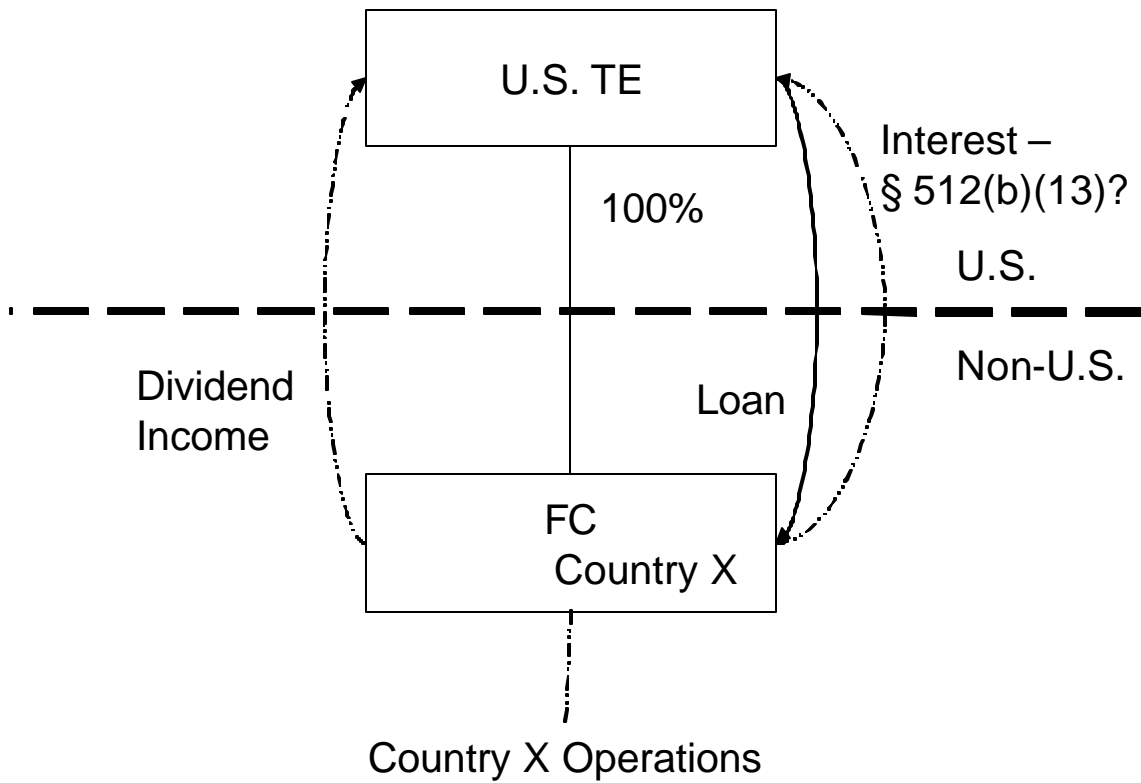
Appendix B

Diagram 1
(Example 1)



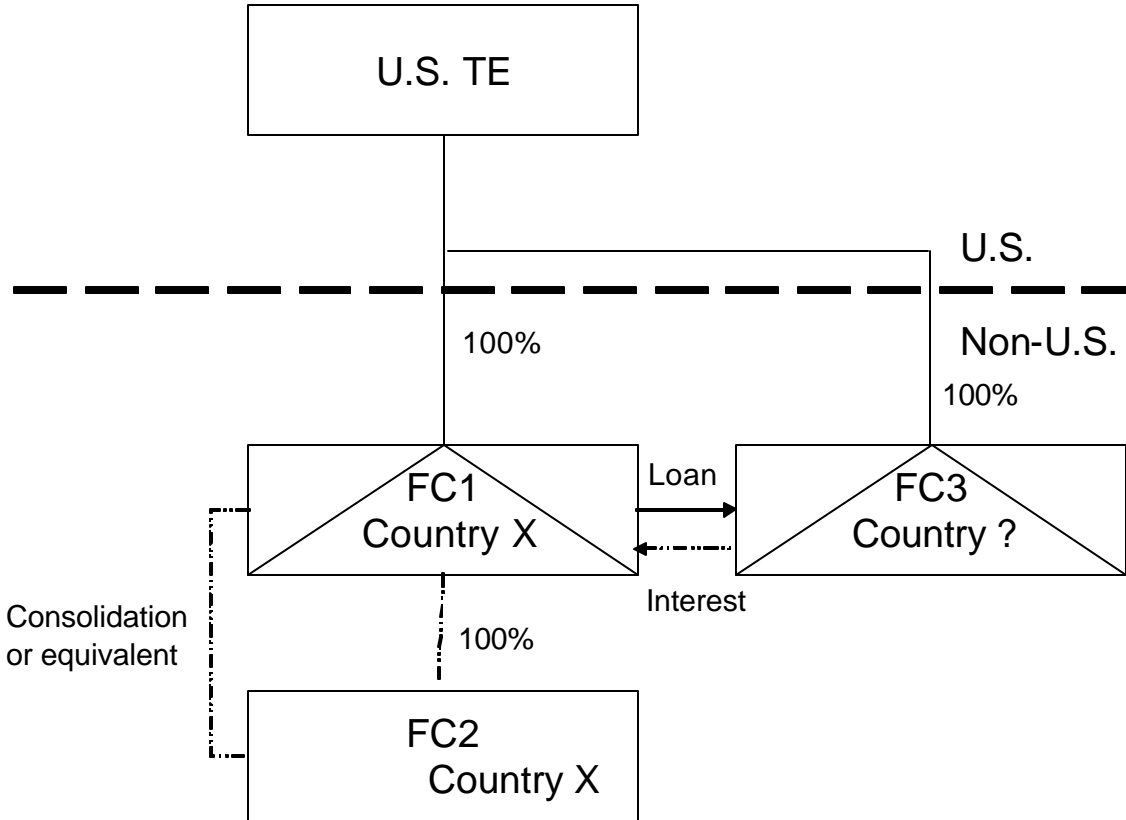
Appendix B


Diagram 2
(Example 2)



Appendix B

Diagram 3
(Example 3)



	Local Law Corporation		U.S. Law Disregarded Entity Corporation
	Local Law Corporation		U.S. Law Corporation