Repeal the Debt-Financed Rule as Applied to Exempt Investors in Funds

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Congress could accomplish significant structural tax reform simply by repealing section 514 as applied to investments by pension funds and other exempt investors in investment funds that employ leverage at the fund level. Thoughtful commentators have been calling for the simplification, if not outright repeal, of section 514 for years.¹ This reform was proposed in 2007 but went nowhere.² As this article went to press, House Ways and Means Committee member Sander M. Levin, D-Mich., introduced a similar reform bill, H.R. 3497.

Section 514 was enacted in 1969 to combat a specific tax abuse made famous by the Clay Brown case.³ It is designed to prevent tax-exempt organizations from leveraging off their exemption by making leveraged, “bootstrap” acquisitions of property from taxable sellers. Because an exempt owner does not pay tax on many types of income generated by property, it can earn a tax-free yield while passing on a portion of its benefits to the taxable seller. Section 514 attempted to address at least part of that tactic by imposing tax on a tax-exempt organization’s income attributable to debt-financed property.

²This provision was in section 612 of H.R. 3996, the Temporary Tax Relief Act of 2007. H.R. 3996 was ultimately enacted as the Tax Increase Prevention Act of 2007, but the provision did not make it into the final legislation.
An example in the regulations under section 514 posits that a tax-exempt organization that is a partner of a partnership will be treated as if it incurred its share of any acquisition indebtedness incurred at the partnership level.\(^4\) While that interpretation makes sense as an antiabuse rule — for example, when an exempt organization forms a partnership to avoid section 514 — the policy of section 514 is not implicated when an exempt organization invests in a widely held fund formed as a partnership.

Most investment funds (including hedge funds, venture capital funds, buyout funds, and private equity funds) borrow to make acquisitions of investment assets, and most have a significant number of tax-exempt partners, including pension funds, university endowments, and other exempt organizations. Most of those investors do not expect to pay tax on unrelated debt-financed income; some of them would lose their exemption entirely if any of that income were earned. Accordingly, the principal effect of section 514 in the investment industry is to force investment funds to use foreign feeders and blockers, set up in tax-neutral jurisdictions such as the Cayman Islands, to avoid section 514.

Given that no policy is served by applying section 514 in those cases, and given Congress’s distaste for offshore fund vehicles, repeal of section 514 as applied to leveraged investment funds would simplify the law without forgoing revenue (none is raised anyway) and would permit this important class of U.S. investors to invest directly without resorting to offshore secrecy jurisdictions. Repeal of section 514 in this context would increase transparency and be entirely revenue neutral. It would promote efficiency by freeing up fund managers and their advisers to concentrate on more important matters than setting up complex alternative investment vehicle and blocker structures. In short, it would be a win-win for all interests involved.

Some in Congress may believe that pension funds should pay some tax on their investment income. However, section 514 raises no tax revenue because it can be planned around. If one believes

\(^4\)Reg. section 1.514(c)-1(a)(2), Example (4).
that the nation’s pension savings should contribute to the tax system, a simpler and fairer way to raise revenue from pension fund investors might be to use a provision already in the code, namely the excise tax imposed on private foundations by section 4940. That tax could be applied at a low rate to the investment income and gains of pension funds. Not only would the tax raise significant revenue in recovering markets, it would be easy to collect and administer and hard to evade, and it would have no competitive or geographic cost of living externalities. It would be borne by all individuals who have savings in proportion to those savings. The proceeds of the tax could be earmarked to pay for healthcare or retirement benefits for the uninsured.