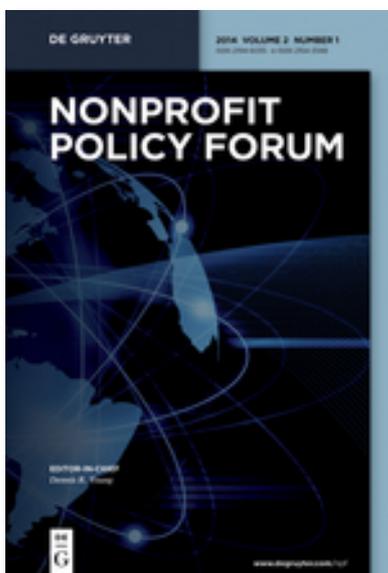


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# The Use of Offshore Blocker Corporations by U.S. Nonprofits: Should Blockers Be Blocked?

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# Abstract

Many U.S. nonprofits use offshore blocker corporations to avoid paying the debt-financed unrelated business income tax (UBIT). Some lawmakers and commentators, however, criticize the practice as abusive. This article takes a closer look at the issue. It concludes that the use of offshore blocker corporations does not undermine the main purposes of the debt-financed UBIT, but that the practice nevertheless raises some serious policy concerns. The article thus recommends that Congress reform this tax: either by eliminating the blocker corporation workaround to the debt-financed UBIT or, alternatively, by repealing the debt-financed UBIT completely but leaving in place or even expanding the debt-financed UBIT's reporting requirements.

**Keywords:** UBIT; UBTI; tax haven; blocker; tax

## 1 Introduction

Like their for-profit counterparts, tax-exempt American nonprofit organizations sometimes set up, manage, and/or invest money in foreign legal entities.<sup>1</sup> In some instances, the use of foreign entities by nonprofits is clearly benign and, from both a legal and a policy standpoint, unobjectionable. A nonprofit's mission, for example, may be to provide services outside the United States, and to accomplish this mission, a nonprofit may have no choice but to use subordinated or affiliated foreign legal entities. In other instances, however, the permissibility or desirability of using foreign legal entities may be less clear, as some lawmakers and commentators have suggested is the case with nonprofit investment in "offshore" funds, i.e., funds organized in a foreign tax haven jurisdiction.<sup>2</sup> Nonprofit organizations frequently invest in offshore rather than domestic investment funds to avoid incurring federal income tax liability, i.e., the debt-financed unrelated business income tax (UBIT), and the additional income tax reporting obligations that go along with it. Under current law, such tax structuring is legal. But there has been debate on whether the practice is proper and should continue to be permitted in the future.

This article looks at the use of foreign blocker corporations by public charities and private foundations organized in the United States, i.e., tax-exempt nonprofit organizations registered under I.R.C. § 501(c)(3), to avoid the debt-financed UBIT. The article forms part of a larger project exploring whether, as critics have argued, offshore operations by nonprofits amount to illegitimate "gaming" or instead merely represent "navigation" of the current legal and tax regime. "Gaming" is a term that suggests that nonprofits exploit weaknesses in laws designed to protect the public and the public fisc. "Navigation," in contrast, is a term that suggests that nonprofits, buffeted by a cumbersome tax and governance regime, use legal structures to negotiate a difficult path toward accomplishing their missions.

What we argue below is that permitting the use of foreign blocker corporations does not undermine the original purposes of the debt-financed UBIT, but that it nevertheless does raise some policy concerns. The majority of nonprofits that operate internationally have good reasons for doing so, and this is true as well for those nonprofits that invest in offshore investment funds. Nevertheless, permitting the use of foreign blocker corporations to avoid the debt-financed UBIT may be problematic because it incentivizes nonprofits to invest through offshore rather than domestic vehicles and makes nonprofit investments less transparent.<sup>3</sup> Congress might thus want to consider reforming this area of nonprofit tax law. Congress could address these concerns by blocking the use of foreign blocker corporations to avoid debt-financed UBIT, as some lawmakers have proposed. Or Congress could instead repeal the debt-financed UBIT rules but leave in place and even expand current reporting requirements for leveraged investments.

This article consists of four main parts. [Section 2](#) reviews the international activities of nonprofits and how they may lead to monetary transfers to foreign legal entities. [Section 3](#) then looks at how the debt-financed UBIT encourages nonprofits to invest in tax haven jurisdictions. [Section 4](#) considers whether the use of blocker corporations should be viewed as gaming or navigation of the legal and tax regime. Finally, [Section 5](#) provides some suggestions as to how the current debt-financed UBIT regime, together with the use of blocker corporations, could be reformed.

## ➤ **2 International Operations**

## ➤ **3 Debt-Financed UBIT and Offshore Investment**

## ➤ **4 Gaming or Navigation?**

## ➤ **5 Approaches to Reform**

## ➤ **6 Conclusion**

## ➤ **Footnotes**

## About the article

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