

# Endowments and Offshore Tax Havens

02.07.18 | Linda J. Rosenthal, JD



In recent years, Congress has made no secret that it has concerns about the billion-dollar endowments of certain tax-exempt colleges and universities. A particularly troubling aspect, in the view of lawmakers and many in the general public, is the rapid jump in tuition costs at American schools at a time when the wealthiest institutions appear to have comfortable cushions of cash. Lawmakers asked pointed questions and the colleges and universities pushed back hard with forceful defenses.

It is no surprise, then, one of the provisions of the recently enacted Tax Cuts and Jobs Act of 2017 is a 1.4% investment-income excise tax on the nation's most generously funded tax-exempt schools. An event that likely bolstered support for this special new tax was the publication last fall of the so-called Paradise Papers in newspapers around the world. Splashy headlines in the United States included provocative information that wasn't widely known here; over 100 private *and* public colleges and universities have been parking large amounts of endowment cash in Caribbean tax havens.

## *Chilly Reaction to Endowments News*

The Paradise Papers is the name given to a leaked stash of some 13.4 million, confidential, electronic documents showing offshore investments by the rich and famous. In early November 2017, a coalition of international investigative reporters published information sourced primarily from Appleby, a prominent and respectable offshore law firm, which routinely facilitates the funneling of money to tax-haven jurisdictions.

The 120,000 files reveal the offshore finances of some of the world's largest companies and wealthiest people and influential people. Among them are Queen Elizabeth II, U.S. Commerce Secretary Wilbur Ross, and other well-known names. What was particularly shocking was the disclosure of offshore activities by 104 United States universities and colleges, ranging from state

schools like Ohio State and Rutgers to Princeton and other Ivy League institutions.

Many Americans, on and outside university campuses, were shocked and dismayed by headlines like these: “Endowments boom as U.S. universities bury earnings overseas: American universities are using offshore strategies to swell their coffers, skirt taxes and obscure investments that could spark campus protests.”

This reaction stems from a vague sense of “ickiness”: Is it legal or ethical? What’s with all the secrecy? What kinds of shadowy investments are being made with this money?

## So, Is it Legal?

In an in-depth investigative series, [W]hat are the Paradise Papers and what do they tell us?, British reporters from *The Guardian* explain that “[m]ost people do not understand the complexities of offshore tax. They have no need to .... “

In the 1970s, offshore tax arrangements became a popular way for people to “hide their money from corrupt and predatory governments in unstable countries, or for banks to move cash around to avoid fluctuations in currency rates.” In these circumstances, the secrecy and generous tax advantages “made them the investment place of choice for the rich and famous who wanted legitimate but tax-efficient investments for their wealth.” Over the past decades, these tax-haven arrangements have “grown exponentially.”

The Paradise Papers reveal the many ways that entities and individuals can “avoid tax using artificial structures.” Offshore tax arrangements “are legal if run correctly.” Some are; some aren’t. “Appleby certainly has a reputation as a respectable company; ... it has a blue-chip clientele that includes some of the wealthiest companies and individuals in the world.”

In *The Use of Foreign Blocker Corporations by U.S. Nonprofits: Should Blockers Be Blocked?*, Professors Norman I. Silber and John C. Wei, of Hofstra and Yale, present a clear and excellent – if not wonky – explanation of the law that applies to the situation just recently revealed to the general public. They also explain the policy arguments for and against it.

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*Legitimate tax avoidance—as opposed to illegal tax evasion—is, by definition, never abusive. As Judge Learned Hand famously noted, ‘[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.’*

Yes, there *was* a famous and often-quoted judge named Learned Hand.

The bottom line is that, under current law, the use of offshore tax accounts by American nonprofit institutions of higher learning – (if structured correctly, and these institutions have excellent counsel) – are legal methods of tax avoidance. Lawmakers know all about it. They have considered tweaking the tax code to curb or eliminate it, but have not done so yet – directly.

Here’s how it works. Generally, U.S. tax-exempt organizations are exempt from federal income tax.

There are some exceptions, though, including the unrelated business income tax (UBIT). Ordinarily, passive investment income is outside UBIT's reach. But if an investment is "debt-financed," it moves back into UBIT territory: an exception to the exception, so to speak. In the offshore situation, the critical element is a "blocker corporation," set up under the laws of a Caribbean jurisdiction and not subject to U.S. taxation. For U.S. nonprofits, use of this device successfully shields them from any pesky UBIT exposure at all as to money parked offshore.

"Under the current US tax structure, schools have an incentive to move offshore because it allows them legally to avoid paying federal tax on hedge fund and private equity investments."

### *Is it Ethical or Moral?*

A key question going forward is whether there are reasons to look beyond the legality issue into the ethical sphere, particularly in the case of nonprofit universities which have become "big players in offshore games. In contrast to the stated mission of open discourse espoused [by them], investments are frequently held in secret entities that help them minimize their contribution to the public purse."

Law professors Silber and Wei explore this issue from both the legal and policy angles. They "conclude 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." They recommend a choice of reforms: either take away the "blocker corporation workaround to the debt-financed UBIT" or repeal the "debt-financed UBIT completely" but leave in place or even expand the reporting duties relating to debt-financed UBIT.

Professor Sam Brunson of Loyola (Chicago) University agrees that the "common university practice of investing in funds that are housed in offshore tax havens" is legal. "There may be bad things about it—I don't like the fact that we send a lot of money through tax havens—but that's the way the tax law is written...It's not morally good or morally bad."

In a recent statement responding to the news about, and criticism of, the offshore investments, Northeastern University voices the position generally taken by universities engaging in this practice: "[I]nvestments 'were managed to maximize the opportunities for furthering our educational and research mission. It is important that we diversify our portfolio to maximize the return on these investments within the strict guidelines of the law."

In the recent Tax Cuts and Jobs Act, lawmakers could have but did not act on recommendations that they directly address offshore tax-haven activities through tweaks of the UBIT law. Instead, they added the 1.4% excise tax on investment income of the highest-dollar endowments. This may *indirectly* achieve some of the same result.

### *What About the Investments?*

Perhaps the most explosive aspect of the Paradise Papers revelations is that many universities' investments in offshore tax havens relate to deeply unpopular activities.

The reaction by student groups and other vocal critics has been swift and strong, particularly at those institutions that have made a public showing of apparent support for sustainable activities and environmental concerns.

A typical example is Northeastern University which "prides itself on being at the forefront of

sustainability.” Its “secret investment in an aggressive financial backer of carbon-emitting industries came as a surprise to members of DivestNU, a coalition of student groups campaigning for a fossil-fuel-free campus. “The university’s motto is ‘light, truth and virtue’,” remarked one member. “Now we learn that the leadership team has been operating in darkness, violating their own green principles by investing in oil and gas, and going offshore to pay less tax.”

Similarly, at the University of Pittsburgh, which the public now knows has investments tied to fossil fuels, a student member of the Fossil Free Pitt Coalition said, “We are concerned about the lack of transparency, as two-thirds of the endowment is just a mystery to us....We are suspicious about where that huge segment of the endowment is going.”

## *Conclusion*

The debate about the November 2017 Paradise Papers’ revelations and their implications for American colleges and universities is just beginning.

If “[a] university is, first and foremost, a social undertaking to create a social good,” can or should that institution “act in ways that deprive the public sector of needed resources to address social problems”?

Politicians around the world and in the U.S. are beginning to ask whether offshore tax havens should be banned. Are they fair? Are they moral? A fundamental question posed by the Paradise Papers is “has tax avoidance in all its guises gone too far?”

In the United States Congress, there may be additional legislative action in the future including – for instance – laws mandating that wealthy institutions do more to help out their students meet crushing tuition and costs obligations.