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**Fiscal Reforms for a More Sustainable Future in America**

**By Charles R. Irish[[1]](#footnote-1)**

**Part 1: Introduction**

**In Celebration of Professor Satoru Osanai.**

 This paper is dedicated to an outstanding individual, Satoru Osanai, on the occasion of his 70th birthday.

 In the early 1980s, Sato’s mentor at the University of Wisconsin, Sam Mermin, introduced me to Sato and asked Sato to help bring more Japanese and East Asian content into the University of Wisconsin Law School. Sato took this task very seriously and he was tireless in his extensive efforts to introduce the Law School’s dean, the University’s chancellor and other people at the University of Wisconsin to the Japanese legal profession and the legal academy. Many of the UW Law School’s current ties with Japanese academic institutions have their origins in Sato’s work on our behalf. Sato also was a major influence in the creation of the UW Law School’s East Asian Legal Studies Center and it was not an accident that Japan dominated the agenda of the EALSC for the first decade of its existence.

 My association with Sato has had the good fortune to extend beyond legal education. It was Sato who introduced me to the joys of golf in Japan and since then we have shared many rounds in Japan and the US, often in the company of Sato’s wife, Mitchiko. Sato and Mitchiko were typically my hosts when I was in Tokyo, which is how I came to know their two sons, Shingo and Gota and then later their grandchildren. Also on the social side, I was able observe Sato as the superb sushi chef he is and to participate in the family style drinking at the local tavern.

 Sato is a complete human being. He is an accomplished administrator, scholar and teacher. He is very much devoted to his wife and family and he has exceptional loyalty towards his friends. What a joy and an honor it has been for me to work and play with Sato over the past several years.

**Introduction to the Topic of This Essay.**

 The federal tax system in the US is highly dysfunctional and exceptionally opaque, which surely makes it an accurate reflection of the political process that created it. On rare occasions, however, the complexities and irrationalities of the tax system become so extraordinary that the pressure for meaningful reforms cannot be ignored. The Tax Reform Act of 1986 was the last time this occurred; but, as this paper is being written (fall, 2012), there are hopeful signs that significant tax reforms soon may again be on the national political agenda. Among the issues that are likely to be considered are proposals for broadening the income tax base, which is the principal objective of the two recommendations of this essay: taxing all the unrelated income of non-profit organizations and mutual benefit associations, which is discussed in Part 2, and ending the unilateral exemption for foreign based sovereign wealth funds, which is discussed in Part 3. Extending the income tax base to more fully include non-profit organizations, mutual benefit associations, and foreign owned sovereign wealth funds will not eliminate the federal government’s deficit, but it will contribute billions of dollars towards fiscal solvency. These proposals also will make the federal tax system fairer with a reemphasis on taxing a broad base according to the ability to pay and benefit concept[[2]](#footnote-2) rather than perpetuating significant tax preferences for politically potent interest groups.

**Part 2: Taxing the Unrelated Income of Tax Exempt Organizations**

**in the United States.**

**Tax Exempt Organizations: An Introduction to Non-Profit Organizations and Mutual Benefit Associations.**

There are two main types of organizations that qualify for an exemption from federal income taxes under IRC section 501(c): non-profit organizations and mutual benefit societies. The federal income tax status of these two groups is the focus of this part and, to anticipate the conclusions later in this part, the principal proposal in this part is to recommend taxing all of the income unrelated to the exempt purposes of these two groups. Because the federal income tax already extends to the income from the active conduct of unrelated businesses, the effect of this proposal would be to extend the income tax to the passive investment income of non-profit organizations and mutual benefit associations.

There is a third, very important group of organizations exempt from the federal income tax under a separate part of the federal tax law[[3]](#footnote-3) - pension, profit sharing and stock bonus plans. This third group of organizations has very substantial passive investments. The California Public Employees Retirement System, for example, has total assets of $244.5 billion[[4]](#footnote-4) and TIAA CREF (the national teachers’ union) manages about $487 billion.[[5]](#footnote-5) Some sovereign wealth funds also fall in this category, such as the Norwegian National Welfare Fund. [[6]](#footnote-6) Since the accumulation of passive assets is precisely why these organizations qualify for tax exempt status, the proposal described in this part to tax all of the *unrelated* income of tax exempt organizations would not affect the pension, profit sharing and stock bonus plans, so they are not discussed further in this paper. Instead, this part of the paper focuses on non-profit organizations and mutual benefit associations, which do have substantial income unrelated to their exempt purposes.

 ***Non-Profit Organizations.*** The non-profit sector is a big and robustly growing part of the US economy. Between 2001 and 2011, the number of non-profits increased 25 percent from 1,259,764 million to 1,574,674 million today.[[7]](#footnote-7)  During that decade, the growth rate of the non-profit sector surpassed the rate of both the business and government sectors.[[8]](#footnote-8)

 In 2010, non-profits contributed products and services that added $779 billion to the nation’s gross domestic product or 5.4 percent of GDP.  Non-profits are also a major employer, accounting for 9 percent of the economy’s wages, and over 10 percent of jobs in 2009.[[9]](#footnote-9) In addition, in 2010, 62.7 million volunteers gave 8.1 billion hours of services with an estimated value of $173 billion.[[10]](#footnote-10)

 The nature of non-profits is commonly misunderstood. In spite of what its name implies, the non-profit sector is occasionally[[11]](#footnote-11) wildly profitable and the people who are closely associated with non-profit organizations sometimes enjoy exceptionally comfortable life styles.[[12]](#footnote-12) Designating an organization as “non-profit” does not require that it not operate at a profit; instead, it only means that the organization must be created so that no individuals or other private parties are its owners. Unlike “for profit” organizations that distribute their profits to shareholders, partners or other owners, non-profit organizations cannot distribute their profits or other assets to private owners.[[13]](#footnote-13)

 Non-profit organizations come in many forms. The terms “charitable organization” and “non-profit organization” are sometimes used interchangeably, but in fact charitable organizations are only an important subset of the broader group of non-profit organizations. Included as non-profit organizations are the following:[[14]](#footnote-14)

* Churches, synagogues, mosques, temples, shrines and other religious organizations;
* Colleges, universities, parochial schools, preparatory schools and other educational institutions;
* Hospitals;
* Public charities, such as the American Red Cross and the United Way;
* Private foundations, such as the Bill and Melinda Gates Foundation, the Ford Foundation, and the Starr Foundation;
* Museums and centers for performing arts, such as the Getty and Frick museums, the Kennedy Center, and Carnegie Hall;
* Political organizations, including the League of Women Voters, the American Association of Retired Persons, the National Rifle Association, the Republican, Democratic and Communist parties, and political action committees; and
* Service clubs, such as Rotary International and the Kiwanis Clubs.

***Mutual Benefit Associations.*** The federal income tax exemption also extends beyond non-profit organizations to include mutual benefit associations. Unlike the more common non-profit organizations which cannot make distributions to benefit members or other private parties, mutual benefit associations are specifically created to produce member benefits (such as improved working conditions through collective bargaining by labor unions and educational and promotional benefits by trade associations) or to provide facilities (such as golf, tennis, swimming, or dining facilities) for a group of members that would not be feasible for the members to do individually. Some of the better known mutual benefits associations are:

* Labor unions, such as the AFL-CIO and UAW;
* Social clubs, including country clubs;
* Trade associations, such as the American Association of University Professors, the National Football Leagues and the National Basketball Association, the US Chamber of Commerce, the American Bar Association, and the American Medical Association.

The distinction between non-profit organizations and mutual benefits associations is not always absolute. In some cases, mutual benefit associations spin off their non-profit activities into separate entities that then qualify as tax favored non-profit charitable organizations.[[15]](#footnote-15) Thus, the American Medical Association, a mutual benefit association for medical doctors, has created the American Medical Foundation as a tax exempt charity, and the American Bar Association, a mutual benefit association for lawyers, has established the American Bar Foundation to carry on charitable and educational activities related to the legal community.[[16]](#footnote-16) There are numerous other examples of organizations that have spun off their charitable activities into charitable foundations as a brief look at the US Treasury’s exhaustive list of tax exempt organizations makes clear.[[17]](#footnote-17)

**A Brief History of the Federal Income Tax Exemptions for Non-Profit Organizations and Mutual Benefit Associations.**

The federal income tax exemptions for charitable, educational, religious organizations, mutual benefit societies and a variety of other non-profit organizations had antecedents dating back to the British Statute of Charitable Uses of 1601 and 19th Century state constitutional provisions.[[18]](#footnote-18) The federal income tax exemptions first appeared in the Revenue Act of 1894 and were included when the corporate income tax was introduced in 1909 and the individual income tax of 1913. During these formative times of the federal income tax and for several decades thereafter, there were no thoughtful explanations for the tax exemptions within the government or by the professional commentators.[[19]](#footnote-19) The absence of debate about the tax exemptions may have been because the policy bases for the exemptions seemed self-evident, because the exemptions were politically impregnable, or because non-profit organizations were just not suitable subjects for an income tax. Whatever the reasons, the federal income tax exemptions for no-profit organizations continued largely unchanged until 1950.[[20]](#footnote-20)

Because mutual benefit societies are intended to provide benefits to their members, the policy justification for their tax exemption generally rested on either of two theories:

1. In the case of labor unions and trade associations, the tax exemption is the equivalent of imputing accumulated income to their members, but then allowing them to deduct these amounts when they are used by the labor unions and trade associations.[[21]](#footnote-21) If an association’s accumulated income allows the dues and fees to be reduced in future years or the activities of the association are expanded without additional cost to the members, the members will deduct smaller amounts in the later years than if they paid in full for the association’s activities.[[22]](#footnote-22) As a consequence, the net revenue effects of a tax exemption for the labor unions and trade associations or taxation of the imputed income with offsetting deductions are essentially the same, except the government loses the time value of the revenue in the former case.
2. In the case of social clubs organized and operated for pleasure, recreation or other non-profit purposes, the tax exemption was largely based on the theory that these personal activities would not be taxed if carried on by each individual member so it did not seem appropriate to impose a tax if the activities are done collectively.[[23]](#footnote-23)

The first major erosion of the income tax exemptions occurred in 1950 with the introduction of the unrelated business income tax (“UBIT”) on most tax exempt organizations.[[24]](#footnote-24) When an exempt organization carries on an active business unrelated to its exempt functions, the net income from the business is subject to tax at the regular corporate tax rates.[[25]](#footnote-25) The UBIT was enacted because of Congressional concerns that non-profit organizations were trading on their tax exempt status, which purportedly gave them a competitive advantage over for-profit companies in the same line of business.[[26]](#footnote-26) The UBIT has a major impact on the activities of some tax exempt organizations. Still, there are some gaps in the UBIT because it only applies to the income from businesses that are not closely associated with the exempt purposes of the non-profit organizations and the determination of a “close association” has allowed significant sources of income to fall outside the UBIT and within the tax exemption. The hundreds of millions of dollars received by universities for the sale of television and radio broadcast rights to athletic events, for example, are not unrelated business taxable income because the IRS has determined that the athletic events are part of the universities’ educational purposes.[[27]](#footnote-27) Sponsorship payments, such as payments to trade associations by for-profit companies in order to be listed as a corporate sponsor of a convention and payments to universities to be the exclusive suppliers of clothing, soft drinks or other products, also are usually arranged so that they are not subject to the UBIT.[[28]](#footnote-28)

Apart from the logical exclusion of income related to the exempt purposes of tax exempt organizations which is not subject to the UBIT, the most important exception to the UBIT is that it does not apply to most passive investment income received by non-profit organizations or mutual benefit associations.[[29]](#footnote-29) Dividends, interest, rents, royalties and capital gains are not subject to the UBIT, presumably because the receipt of passive income seems more consistent with non-profit status and passive investments raised less concerns about anti-competitive behavior.[[30]](#footnote-30)

The passive income exception is itself subject to an important exception: If the passive income is derived from property subject to “acquisition indebtedness,” a portion of that income is subject to UBIT.[[31]](#footnote-31) Acquisition indebtedness is defined as debt incurred to acquire or improve the income producing property.[[32]](#footnote-32) Congress felt that it was necessary to tax the income from debt financed property to keep the exempt organizations from trading on their tax exempt status by borrowing money to acquire property and then using tax free income to pay off the debt.[[33]](#footnote-33) According to the Congressional reports in 1950, these debt financed “bootstrap” transactions created the possibility that tax exempt organizations would soon own the great bulk of commercial and industrial real estate in America.[[34]](#footnote-34)

The second major legislative attack on the tax exempt status of non-profit organizations and mutual benefit associations occurred in 1969. At that time, the principal focus was on private foundations, which for a number of reasons had attracted the attention of the US Congress. Private foundations are charitable organizations that derive the bulk of their support from a limited number of people (often a single person, a single family, or a single corporation) and that are not directly engaged in charitable activities. In the 1950s and 1960s, some of the private foundations had provided support for voter registration drives in the Deep South and financed other causes that were viewed with considerable hostility among those in political power at the time, so it was not surprising that Congress sought to limit the influence of private foundations. The major new provisions directed at private foundations consisted of a series of excise taxes that limited how foundations could spend their resources, diminished their ability to control private enterprises, and partly withdrew their tax exempt status as to their net investment income. After the 1969 changes, most private foundations were subject to a 2 percent excise tax on their net investment income.[[35]](#footnote-35) In addition, Congress imposed two tier excise taxes on private foundations, foundation managers, and people closely associated with the private foundations aimed at curbing self-dealing transactions, penalizing foundations and their managers for transactions that impaired the foundations’ ability to further charitable purposes, and requiring that foundations make annual minimum distributions for charitable purposes.[[36]](#footnote-36) Congress combined these excise taxes with cumbersome reporting requirements so that private foundations were required to disclose much more about their activities than they had in the past.[[37]](#footnote-37) These disclosures also must be available for public inspection.[[38]](#footnote-38) The tax exempt organizations subject to these disclosure requirements also has been expanded considerably so that they now apply to almost all non-profit organizations and mutual benefit associations.[[39]](#footnote-39)

The 1969 changes also limited the tax exemption for social clubs. Prior to that time, social clubs were able to use their tax exempt status to accumulate investment income free of tax. Since 1969, social clubs have been taxed on their investment income that is not set aside for the clubs’ tax exempt purposes.[[40]](#footnote-40) They also are taxed on the net income received from nonmembers.[[41]](#footnote-41)

In 1975, Congress turned its attention to political organizations, which previously had not been required to file federal income tax returns. In general, after 1975, political organizations are regarded as tax exempt organizations with the consequence that campaign contributions to them are not taxable, but amounts spent for political purposes are not deductible.[[42]](#footnote-42) Political organizations are subject to tax on their net investment income and income from unrelated business activities.[[43]](#footnote-43)

**Taxing the Unrelated Income of Non-Profit Organizations and Mutual Benefit Associations.**

So, at this point, it is apparent that the federal income tax exemption for non-profit organizations and mutual benefit association is not unequivocal and already has several important exceptions. As a result, there now are numerous instances in which the income of non-profit organizations and mutual benefit associations is subject to the federal income tax. Among the major inroads in the exemption for non-profit organizations and mutual benefit associations is that they now are taxed on:

* Income from unrelated trade or businesses;
* Income from debt financed property;
* Net investment income of private foundations;
* Nonmember income and investment income of social clubs; and
* Unrelated business income and investment income of political organizations.

In spite of the erosion of the tax exemption for non-profit organizations and mutual benefit associations, there still are significant amounts of income that continue to be exempt from the federal income tax.[[44]](#footnote-44) By far the most important exemption is for income from passive investments, which continues to be largely exempt from the federal income tax.

***In Defense of Continued Tax Exemptions.*** Of course, there are persuasive arguments for continuing the tax exempt status of non-profit organizations and mutual benefit associations to the extent their income is derived from activities closely associated with the base of their tax exempt status. Income derived by churches from religious activities, by universities for educational services, by hospitals for medical services, by museums and other civic organizations for cultural events, and by other non-profits from performance of their basic functions can be defended under a number of theories. Among the most common theories in support of the tax exemption for non-profit organizations are (i) the government subsidy theory, (ii) the notion that the taxable income of non-profit organizations cannot be accurately measured, and (iii) the theory that non-profits are sovereign organizations parallel to the government.

The most frequent reason given for exempting non-profit organizations is that the government is providing a subsidy to the non-profit sector in the amount of the taxes foregone.[[45]](#footnote-45) The subsidy is justified on the grounds that non-profit organizations are providing services that the government is unable or unwilling to provide.[[46]](#footnote-46)

A small variation on the government subsidy theory is the donative theory developed by Mark Hall and John Colombo.[[47]](#footnote-47) Under this theory, tax exemption is a proper subsidy where neither the government nor the private sector provides a service for a significant number (but not a majority) of citizens. In democratic societies, governments assume duties where there is majority of support. In the absence of such support, needs of significant sectors of society may go unmet. A tax exemption for public service non-profits thus provides a way for the government to subsidize important services without the necessity of majority support or the ability to control the organizations providing the services.[[48]](#footnote-48)

Another variation on the government subsidy theory is the capital subsidy theory developed by Henry Hansmann. Under this theory, the government subsidy of a tax exemption is justified to help non-profits compensate for their inability to raise capital through the issuance of stock and their limited access to traditional forms of debt financing.[[49]](#footnote-49)

The second major reason commonly articulated for the tax exemption is that the receipts and disbursement of non-profits do not fit comfortably within the traditional concepts of the income tax. Boris Bittker and George Rahdert are the principal proponents of the theory that public service non-profit organizations, such as universities and churches, are exempt from tax because their income cannot be accurately measured. In explanation of their theory, they provide the following example:

Assume that a charitable organization’s receipts and disbursements for the year are as follows:

*Receipts:* (thousands)

1.Interest from endowment $100

2. Membership dues 25

3. Gifts and bequests 75

4. Total receipts $200

*Disbursements:*

5. Salaries of staff $ 25

6. Medical welfare program for indigent persons 125

7. Total disbursements $150

*Net:*

8. Receipts less Disbursements (line 4 minus line 7) $ 50[[50]](#footnote-50)

The authors then explain the difficulties in trying to determine which of items 1 – 4 should properly be included in the income tax base and which of items 5 – 7 should be allowed as deductible expenses in determining taxable income. The authors conclude that these difficulties are sufficiently great as to warrant excluding the entire amount from the income tax. They also state that resting the tax exemption for public service non-profit organizations on the difficulties of income measurement is preferable to the government subsidy theories because the latter theories can be used to support the view that the tax exemptions are a loophole in the income tax law and a departure from the normative rules of the federal income tax.[[51]](#footnote-51)

 The third theory formulated by Evelyn Brody is an extension of the doctrine of sovereign immunity under which one government does not challenge or seek to tax the legitimate governmental functions of another government.[[52]](#footnote-52) According to Brody, non-profits, especially churches and other religious entities, are akin to sovereign governments and hence government should not seek to tax or control them as they carry on their public service activities.

There seems to be a greater consensus on the policy bases for exempting mutual benefit associations from tax. The general theory is that mutual benefit associations should be viewed as conduits for their members. Thus, in the case of labor unions and trade associations, the tax exemption is the same as imputing the accumulated income to their members, but then allowing them to deduct these amounts when they are used by the labor unions and trade associations.[[53]](#footnote-53) If an association’s accumulated income allows the dues and fees to be reduced in future years or the activities of the association are expanded without additional cost to the members, the members will deduct smaller amounts in the later years than if they paid in full for the association’s activities.[[54]](#footnote-54) As a consequence, the net revenue effects of a tax exemption for the labor unions and trade associations or taxation of the imputed income with offsetting deductions are essentially the same, except the government loses the time value of the revenue in the former case.

In the case of social clubs organized and operated for pleasure, recreation or other non-profit purposes, the tax exemption was largely based on the theory that these personal activities would not be taxed if carried on by each individual member so it did not seem appropriate to impose a tax if the activities are done collectively.[[55]](#footnote-55)

 It is especially notable that the arguments supporting continued tax exemptions for non-profits and mutual benefit associations are based on the policy reasons for sustaining the exemptions when the tax exempt entities carry on the activities that serve as the bases for the exemptions. The arguments catalogued above explain the policy underpinnings for why churches should be exempt on their religious activities, why schools should be exempt when they provide educational services, and why unions should be exempt when they negotiate for improved working conditions for their members. But these arguments do not deal with the question of the tax status of income generated by activities that are extraneous to the fundamental purposes of the tax exempt organizations.

***In Favor of Taxing Unrelated Income of Non-Profit Organizations and Mutual Benefit Associations.*** As explained previously, the tax exemption for non-profits and mutual benefit associations does not shield income produced from businesses that are unrelated to the exempt purposes of the organizations and associations, but passive investment income of tax exempt organizations is still largely untaxed.[[56]](#footnote-56) Congress drew the line between active business income and passive investment income because the operation of businesses by tax exempt entities might give them an unfair competitive advantage, while passive investments were viewed as not threatening to the private sector.[[57]](#footnote-57) But as has been noted for some time, the active/passive distinction is often not apparent. In many circumstances, the conduct may be characterized as active in one context, but passive in another.[[58]](#footnote-58) There also is no reason to think that an income tax exemption in and of itself confers a competitive advantage over taxable enterprises.[[59]](#footnote-59) In addition, it may be naïve to think that passive investments of tax exempt organizations cannot be managed in an anticompetitive fashion,[[60]](#footnote-60) especially now that the accumulated assets of these organizations are being managed by aggressive, sophisticated money managers who receive compensation packages directly comparable to their private sector counterparts.

Of course, the basic distinction between active businesses and passive investments was created more than 60 years when the economic and social impact of tax exempt organizations was less significant and their aggregate passive investments were not substantial.[[61]](#footnote-61) Now, however, the financial picture is very different.

* The combined endowments of colleges and universities are $356 billion.[[62]](#footnote-62)
* The total assets of private foundations after the 2008 financial crisis are estimated at about $560 billion (down from $670 billion at the end of 2007).[[63]](#footnote-63)
* The Archbishop of New York is thought to be the largest landowner in New York City.[[64]](#footnote-64)
* The assets of the Mormon Church (and most other religious organizations) are clouded in secrecy, but the church manages a large number of commercial investments, including a $16 billion insurance company, more than $6 billion in stocks and bonds, a $172 million string of radio stations that was the seventh largest in the country, and about 150 cattle ranches and farms with a land area roughly equal to the State of Delaware, which makes the Mormon Church one of the largest landowners in America.[[65]](#footnote-65)

Other examples of the financial strength of tax exempt organizations are too numerous to list, but the conclusion is clear: many tax exempt organizations are large and they often are exceptionally rich. In addition to being an important part of American culture, the tax exempt organizations now are an important part of the American economy.

There also is no evidence that the active/passive distinction as applied to tax exempt organizations was created after a thorough and thoughtful study. The principal reason Congress articulated for taxing active business income of tax exempt organizations was the concern that their tax exempt status gave them an unfair competitive advantage, but the risk of anticompetitive behavior was based on anecdotal evidence, not after a thorough empirical study.[[66]](#footnote-66) Passive investments were excluded from taxation because Congress assumed, without any careful consideration, that they did not pose competitive risks for taxable businesses with similar investments.[[67]](#footnote-67)

The inescapable conclusion is that the active/passive distinction as applied to tax exempt organizations is untenable. It is doubly untenable in a time of fiscal austerity as the federal government scrambles to cut its deficit before it becomes financial ruinous. Whatever the merits of continuing the tax exemptions for non-profit organizations and mutual benefit associations on their activities that provide the bases for their preferred status, they do not extend to any active or passive income generated by activities that are unrelated to the exempt purposes of these organizations. Instead, tax exempt organizations should be taxed on all of their unrelated income according to the ability to pay concept, one of the most basic tenets of tax policy.[[68]](#footnote-68)

Of course, it may be argued that taxing the passive income of non-profits and mutual benefit associations will cut into their resources and presumably diminish their ability to carry on their exempt purposes. To this argument, there are two responses. First, in defining the net income subject to tax, the non-profits and mutual benefit associations should be allowed to create a deductible reserve for future contingencies. In this way, organizations could accumulate tax free income to the extent reasonably necessary to expand future operations or to cover future shortfalls. The deductible reserve could be similar to the bad debt reserves for banking institutions.[[69]](#footnote-69)

The second response to concerns about taxes diminishing the ability of tax exempt organizations to carry out their exempt functions is that it probably is a good idea for tax exempt institutions to compete in the marketplace for contributions. Why should tax exempt organizations be preferred over new start-ups in the private sector or initial public offerings. If tax exempt organizations have a shortfall or ambitious expansion plans not covered by their contingent reserve, forcing them to appeal to the marketplace will make it likely that their needs are carefully scrutinized and weighed against all other investment/contribution options in both the public and private sectors. Support will be forthcoming only if the appeal for contributions is carefully designed and relevant in the current circumstances.

**Part 3: Income Taxation of Sovereign Wealth Funds**

**Sovereign Wealth Funds: A Primer.**

Sovereign wealth funds (“SWFs”) have existed for a long time, but the sharp escalation in energy prices and the major trade imbalances of several East and Southeast Asian economies have generated significant government surpluses and corresponding growth in the SWFs. Based on information that is generally available, assets under management by SWFs now are approaching US$5,000,000,000,000 (US$5 trillion)[[70]](#footnote-70) and the IMF projects estimates that foreign assets under SWF management will grow to US$6 trillion to US$10 trillion by 2013.[[71]](#footnote-71)

**Major Sovereign Wealth Funds (2012)**

|  |  |  |
| --- | --- | --- |
| Country of origin | Name | Assets under management (US$ billions) |
| UAE – Abu Dhabi | Abu Dhabi Investment Authority | $627 |
| Norway | Government Pension Fund – Global | $656.2 |
| Saudi Arabia | SAMA Foreign Holdings | $532.8 |
| Singapore | Government of Singapore Investment Corporation | $247.5 |
| China | SAFE Investment Company | $567.9 |
| Kuwait | Kuwait Investment Authority | $296 |
| China | China Investment Corporation | $482 |
| China – Hong Kong | Hong Kong Monetary Authority Investment Portfolio | $293.3 |
| Russia | National Welfare Fund | $149.7 |
| Singapore | Temasek Holdings | $157.5 |
| China | National Social Security Fund | $134.5 |
| Qatar | Qatar Investment Authority | $100 |
| Australia | Australian Future Fund | $78.2 |
| Libya | Libyan Investment Authority | $65 |

Source: Sovereign Wealth Fund Institute at <http://www.swfinstitute.org/fund-rankings/>

 (visited September 20, 2012)

The assets under management by SWFs now are greater than the assets managed by private equity and hedge funds (estimated at about US$2.2 trillion in 2007), but the SWFs still represent a small proportion of global financial assets, estimated at US$190 trillion. SWFs also manage much smaller amounts than are held by pension funds (US$26 trillion), mutual funds (US$22 trillion) and insurance companies (US$17 trillion).[[72]](#footnote-72)

SWFs have been in the news only partly because of their rapid growth. In recent years, SWFs based in Kuwait, Saudi Arabia, Abu Dhabi, Qatar, China, South Korea, and Singapore have made several highly publicized investments to bail out Wall Street financial institutions, gain a share in Australia’s mining boom, and take a stake in British and American retail establishments. In 2007, SWFs made over 250 major investments totaling US$70,000,000,000 (US$70 billion).[[73]](#footnote-73) This combination of rapid growth and large, public investments have caused governments in many of the host (or potential host) countries to question whether politically influenced investment strategies of SWFs will have distorting effects on capital markets. The host government also are concerned that SWF investments and disinvestments might become threats to their national security.[[74]](#footnote-74) As a consequence, the OECD has recently issued guidelines for recipient countries policies towards SWFs[[75]](#footnote-75) and the IMF has started a project aimed at developing best practices for host country relations with SWFs.[[76]](#footnote-76) Some of the industrialized countries already have rules that restrict foreign government investments while others treat foreign government control as one of the factors to consider in their reviews of inbound direct investments.[[77]](#footnote-77)

In the discussions about SWFs, however, two questions that have been largely ignored how SWFs are taxed and how they should be taxed. That is the object of this part: specifically, to examine the current tax environment affecting SWFs with the view to identifying appropriate tax policies towards SWFs. First, however, we have to define what is meant by SWFs and then we need to take a brief look at the taxation of foreign investors generally. That is what is done in the next two sections.

***What Are Sovereign Wealth Funds?*** SWFs are essentially assets that governments have decided to keep separate from the usual processes of government budgeting and asset management. There is no single definition that distinguishes SWFs from the many other types of government owned investors active in international markets. Generally speaking, SWFs “are actively managed, government-owned pools of capital originating in foreign exchange assets.”[[78]](#footnote-78)

The US Treasury defines SWFs as government investment vehicles funded by foreign exchange assets and managed separately from official reserves.[[79]](#footnote-79) The IMF also defines SWFs as government owned investment entities funded by foreign exchange assets, but it further differentiates the SWFs based on their purposes. The IMF has identified five categories of SWF:[[80]](#footnote-80)

* Stabilization funds are intended to insulate an economy from adverse changes in commodity prices.
* Savings funds invest the proceeds from the sale of nonrenewable commodities in diversified portfolios for the benefit of future generations.
* Reserve investment corporations are funded by official reserve assets, but are intended to earn greater returns than generally available for official reserves.
* Development funds are intended to support social or economic policies or industrial policies aimed at increasing economic growth.
* Contingent pension reserve funds are organized to cover governments’ contingent pension liabilities.

While most political attention is directed at the large SWFs managed by national governments, the IMF definition of SWFs is sufficiently broad that it may include some government owned and managed pension and savings funds. On the other hand, some of largest state owned enterprises and public pension plans have opposed being characterized as SWFs because of the negative and often hyperbolic publicity associated with SWFs.[[81]](#footnote-81) Included among the larger government owned enterprises and public pension funds that are not regarded as SWFs are the US$244.5 billion managed by the California Public Employees Retirement System (“CalPERS”)[[82]](#footnote-82) and the US$92.6 billion managed by the State of Wisconsin Investment Board (“SWIB”).[[83]](#footnote-83) On the other hand, the State of Alaska’s Permanent Fund with US$39.8 billion, Alberta’s Heritage Fund with US$16.6 billion, and Wyoming’s Permanent Mineral Trust Fund with US$3.9 billion do fit within the traditional definition of SWFs.[[84]](#footnote-84)

**Taxation of Foreign Investors Generally.**

In order to better understand the special tax rules sometimes available to SWFs, it is necessary to review the taxation of foreign investors generally.[[85]](#footnote-85)

Host country tax systems generally allocate the income of foreign investors into three categories. Under the first category, if a foreign investor is directly engaged in commercial activities in the host country, the income derived from the commercial activities is traditionally taxed in the host country on a net basis (i.e., after the cost of goods and expenses incurred in the production of income are deducted from the gross receipts). In such a circumstance, in international tax parlance, the foreign investor is deemed to have a *permanent establishment* in the host country and the income attributable to the permanent establishment is taxed on a net basis.The basic objective is to treat the income of a permanent establishment in the same fashion as the income earned by a domestic enterprise.

Under the second category, outbound remittances of recurrent income, such as dividends, interest, rents, royalties, and compensation for services, are subject to gross withholding taxes. The gross withholding taxes usually only apply when the foreign investor either has no permanent establishment in the host country or the recurrent income is not attributable to the permanent establishment.[[86]](#footnote-86) In the United States, for example, the withholding tax rate applicable to outbound remittances of recurrent income is generally 30 percent of the gross remittance.[[87]](#footnote-87) In Malaysia, the withholding tax rates on the outbound remittances are between 5 and 25 percent.[[88]](#footnote-88) In Australia, the withholding tax rates range from 10 percent on interest to 30 percent on royalties and unfranked dividends.[[89]](#footnote-89) Singapore withholding tax rates range from 10 percent on royalties to 17 percent[[90]](#footnote-90) on management fees and technical assistance and service fees.[[91]](#footnote-91) Japan imposes withholding taxes of 15 percent on interest and 20 percent on dividends.[[92]](#footnote-92)

Income that is neither attributable to a permanent establishment nor recurrent falls into the third category and is generally exempt from host country income taxes. The most common types of income that qualify for the exemption are:

* Gains from the sale of business inventory not attributable to a permanent establishment. Because of expansive definitions of a permanent establishment in many countries, the scope of this exemption is quite narrow.
* Gains from the sale of stocks, bonds, and other securities.
* Interest paid to foreign investors on debt obligations and bank deposits.

In summary, passive foreign investors, irrespective of their status as SWFs or not, often enjoy significant tax preferences in host countries. Both their gains from dealings in stocks, bonds and other securities and the interest they receive on debt obligations are often exempt from host country income taxes. In countries with low or no domestic taxes on dividends, such as Singapore and Australia (on franked dividends), the tax preferences for dividends also may be extended to foreign investors.[[93]](#footnote-93)

**Taxation of Sovereign Wealth Funds: An Overview.**

As mentioned above, the distinction between SWFs and the many other funds owned or managed by governments is unclear. As a consequence, it is not surprising that SWFs generally are taxed in the same fashion as the other government owned or controlled funds. The tax systems applicable to SWFs and other governmental funds fall into three categories that are defined by their underlying policies. The three categories are: (i) unilateral exemption for passive investment income (i.e., dividends, interest and capital gains from dealings in stocks, bonds and other securities); (ii) reciprocal exemptions for passive investment income either under domestic law or as a result of bilateral tax treaties; and (iii) taxation to the same extent as private foreign investors. Each of these three categories is described in greater detail below.

***Unilateral Exemptions*.** In the first category are countries that provide unilateral exemptions for SWFs on their passive investment income. The exemption is granted as an extension of the doctrine of sovereign immunity. Because of the widespread adoption of the *restrictive* theory of sovereign immunity, with immunity no longer applying to commercial activities of foreign government enterprises, the unilateral tax exemptions typically only apply to passive investment income and do not apply to income from commercial activities. The United States, Australia, and the United Kingdom are in the first category.

Under its domestic tax law, the United States grants a unilateral exemption to foreign governments.[[94]](#footnote-94) So long as the SWFs are either an integral part of a foreign government or an entity controlled by the foreign government, SWFs enjoy the benefits of the tax exemption. The exemption applies to interest, dividends and capital gains from dealings in stocks, bonds and other securities. The exemption also applies to capital gains received on the sale of stock in a US real property holding company. On the other hand, gains from the sale of a directly owned US real property interest would be subject to tax. In addition, royalty income, income directly received from commercial activities and dividends and capital gains from a controlled commercial enterprise do not qualify for the exemption.[[95]](#footnote-95)

The Australian exemption for foreign governments is done administratively on a case by case basis. To qualify for the exemption, a foreign government or its agency must establish (i) that the person making the investment (and therefore deriving the income) is a foreign government or an agency of a foreign government, (ii) that the moneys being invested are and will remain government moneys; and (iii) that the income is derived from non-commercial activities.[[96]](#footnote-96) Income derived by a foreign government or by any other body exercising governmental functions from interest bearing investments or investments in equities is generally not considered to be income derived from a commercial operation or activity. In relation to a holding of shares in a company, a portfolio holding of 10 percent or less of the equity in a company is generally accepted as a non-commercial activity and dividends received from such holding are exempt from tax. Direct holdings of real estate are not within the exemption, however, so rental income received from Australian real estate and gains from the disposition of such real estate is not exempt from tax.[[97]](#footnote-97)

The UK exemption for foreign governments also is done administratively. The UK Government has said that where a SWF is an integral part of a foreign government it will benefit from the exemption from UK taxes. Because the UK recognizes the principle of sovereign immunity under which one state does not attempt to tax the activities of another state, the current practice of the UK Government is to treat all passive income and gains beneficially owned by a foreign government as immune from direct taxes.[[98]](#footnote-98) Because the UK limits the exemption to income directly received and beneficially owned by the foreign sovereign government , the UK exemption for foreign governments and their sovereign wealth funds may not be as generous as it appears on first impression.

***Reciprocal exemptions.*** The second category consists of governments that exempt foreign governments and their SWFs only where the foreign governments extend a comparable exemption. The reciprocal exemption is accomplished either domestically or through inclusion in bilateral double taxation treaties.

Revenue Canada has issued the following statement describing its exemption for foreign governments, including SWFs:

*50. Under the Doctrine of Sovereign Immunity, the Government of Canada may grant exemption from tax on certain Canadian-source investment income paid or credited to the government or central bank of a foreign country. Written authorization not to withhold tax is given to the Canadian resident payer upon request after substantiation that such investment income (other than that already exempt under the Act and Regulations) is the property of the government or central bank of a foreign country. …Investment income of a foreign government or its agency is exempt only if (a) the other country would provide a reciprocal exemption to the Canadian Government or its agencies; (b) the income is derived by the foreign government or agency in the course of exercising a function of a governmental nature and is not income arising in the course of an industrial or commercial activity carried on by the foreign authority; and (c) it is interest on an arm's length debt or portfolio dividends on listed company shares. Income such as rentals, royalties or direct dividends from a company in which the foreign government has a substantial or controlling equity interest does not qualify for exemption.[[99]](#footnote-99)*

The bilateral tax treaty between Singapore and Malaysia (effective January 1, 2007) is an example of a treaty based reciprocal exemption for governmental entities. Article 11 of the tax treaty provides that the withholding tax on interest paid to non-residents should not exceed 10 percent. Paragraphs 3 and 4 of Article 11 then provide that Singaporean source interest paid to the Malaysian Government, the governments of the Malaysian states, Bank Negara Malaysia, local authorities, statutory bodies, and the Export-Import Bank of Malaysia Berhad is exempt from tax in Singapore. Malaysian source interest paid to the Singaporean Government, the Monetary Authority of Singapore, the Government of Singapore Investment Corporation Pte. Ltd., and Singaporean statutory bodies is exempt from tax in Malaysia.[[100]](#footnote-100)

Among countries with major government investment funds, including SWFs, reciprocal exemptions by bilateral tax treaties seem fairly common. The bilateral tax treaties between Singapore and Japan (effective January 1, 1996) and Norway and Russia (effective May 17, 2001), for example, contain reciprocal exemptions for interest paid to foreign governments, regional and local authorities and their agencies.[[101]](#footnote-101)

Even though it provides a unilateral tax exemption for foreign governments and their agencies, the United States also has obtained exemptions for its government funds, including subnational SWFs, such as the Alaska Permanent Fund, and subnational government investment funds that are not SWFs, such as the California Public Employees Retirement System (CalPERS) and the State of Wisconsin Investment Board (SWIB). The recent amendment (May 2, 2006) to the US bilateral tax treaty with Denmark provides for reciprocal exemptions for dividends,[[102]](#footnote-102) while the original treaty provides a general exemption for interest paid to residents of the other country.[[103]](#footnote-103) The US tax treaties with Switzerland and the Netherlands also provide limited exemptions for pension funds, including government owned pension funds such as CalPERS and SWIB.[[104]](#footnote-104)

***No special exemptions*.** In the third category are countries that have no special provisions for SWFs and other government owned and controlled entities. Presumably the dominant policy underpinning this category is the notion of taxpayer equity. Under this policy, since all foreign investors, irrespective of their ownership or the source of their funds, obtain benefits from the host country’s infrastructure and the investment opportunities it offers, they all should be subject to the same level of taxation. Hence, under the third category, there are no special preferences for foreign governments and their SWFs.

Germany has no special provisions for foreign governments, including SWFs. The result is that foreign governments and their SWFs are taxed in the same fashion as foreign corporations investing in Germany. The absence of any special tax preferences is softened, however, by the generally benign tax system applicable to foreign investors. Under Germany’s domestic tax laws, foreign investors’ interest income and capital gains from shares are generally exempt from tax. In addition, foreign corporations, including foreign governments and SWFs, are not taxed on 95 percent of the dividends they receive from German corporations. The net result is that all foreign investors in German actually pay little tax on their passive investments, so the absence of special tax benefits for foreign governments and SWFs is not very notable.[[105]](#footnote-105)

On the other hand, Taiwan, New Zealand, and South Korea do have significant withholding taxes imposed on outbound remittances of passive income and they appear to have no special tax preferences for foreign governments, including SWFs. It may be that if the markets for global capital become tighter these governments will feel pressure to offer some tax preferences to large government investment funds, including SWFs.

**Taxation of Sovereign Wealth Funds: Conclusions and Recommendations.**

Governments’ attitudes towards the taxation of SWFs certainly are not uniform. Some countries, such as Singapore and China, are awash in capital and may feel little pressure to unilaterally offer special tax preferences to SWFs and other government owned investment funds. On the other hand, as the home to some of the major SWFs, these countries are precisely the ones that are likely to be concerned about the tax treatment of their SWFs in other countries. This suggests that for such countries a policy that offers tax preferences on a reciprocal basis would be attractive.

It does appear that the United States, with its unilateral exemption, is overly generous. It may be that the American need for capital inflows currently is so great that the United States cannot jeopardize continuing investments from the Middle Eastern or Asian based SWFs. The current system does, however, put the many American based SWFs and other national and subnational government owned funds at a negotiating disadvantage as they seek tax preferences in other countries. If the other countries do not already grant tax preferences, as Norway, South Korea, Taiwan, and New Zealand do not, the United States unilateral exemptions for foreign governments and their SWFs create no incentive for those countries to provide tax preferences comparable to the exemptions available in the United States. Therefore, it seems that the United States also should consider moving away from its unilateral exemption towards exemptions available on a reciprocal basis. The reciprocity could be done either through a change in domestic law, such as is done in Canada, or through the negotiation of tax treaties, as Singapore, Russia, Norway, and Malaysia have done. The major problem with the tax treaty approach is that the glacial pace of treaty negotiations means that our grandchildren will be well into their professional careers before the change in policy has a noticeable effect. On the other hand, offering reciprocal exemptions by bilateral tax treaties may encourage the negotiation of tax treaties between the United States and many of the states in the Middle East where the SWFs are located. Since the United States has few tax treaties effective in that region, this may be an in important consideration among US tax policy makers.

From a tax policy perspective, the most reasoned approach is probably the third category – to not offer any special tax preferences for foreign governments and their SWFs. In fact, a good case can be made for taxing all foreign investors, including large charitable organizations, on the same basis. The competition for foreign government investments, including SWFs, is likely to intensify, however, as potential host governments come to recognize that the great preponderance of these investments are long term and stable. It may be that competitive pressures for foreign capital force the Taiwanese, New Zealand and South Korean governments to adopt a more attractive tax system for investments by foreign governments and their SWFs.

**Part 4: Conclusions.**

For fiscal year 2011, the US Government had receipts of $2,303,000,000,000 ($2.3 trillion), which is an enormous amount of money. Unfortunately, for the same period, the US Government spent $3,598,000,000,000 ($3.6 trillion), which is an even larger amount and resulted in a federal government deficit of $1,295,000,000,000 ($1.3 trillion).[[106]](#footnote-106) In more understandable terms, for every $100 the US Government spent, $36 had to be borrowed. Individual households and private sector businesses with such a mismatch between receipts and expenditures quickly wind up in bankruptcy court. As a percentage of their GDP, Greece and Spain, two of the sickest economies of Europe, have deficits comparable to or lower than the US Government deficit[[107]](#footnote-107) and it is widely thought that even the US Government cannot sustain such fiscal imprudence.[[108]](#footnote-108) The problem of the deficit is getting so severe in the US that even the gridlock in Congress may not stop the movement towards greater fiscal responsibility. Cuts in US government expenditures seem inevitable, but meaningful tax reforms also are a possibility. Included among any tax reforms would be plans to broaden the base of the federal income tax so that the tax burden is spread more evenly according to the ability to pay principle or, in the case of foreign entities, according to the benefits principle. It is with the possibility of major tax reforms in mind that the two proposals described in Parts 2 and 3 are put forward. Taxing all of the unrelated income of tax exempt organizations and the income of sovereign wealth funds is consistent with the ability to pay concept as to domestic entities and the benefits principle for the foreign sovereign wealth funds. It also will put billions of dollars in the US Treasury at a time when the US Government is very much in need of new sources of revenue.

In conclusion, the proposals to tax all of the unrelated income of exempt organizations and sovereign wealth funds are well worth serious consideration.

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In preparing this essay, I had excellent research support from University of Wisconsin SJD candidate Kim Yong Sung. While the quality of the research support was superb, any stylistics errors and substantive mistakes are completely the author’s responsibility. [↑](#footnote-ref-1)
2. The two basic tenets guiding the design of tax systems are the ability to pay theory and the benefit theory. The ability to pay theory says that each taxpayer should bear taxes according to his/her/its ability. Under this theory, wealthy taxpayers should pay more and poor taxpayers should pay less, although there is significant dispute about how much or how much less they should pay. The benefit theory says that taxpayers should pay taxes because they benefit from the government expenditures in the form of infrastructure and overall economic stability. The benefit theory is the base for government user taxes, such as the excise taxes on gasoline and tires. [↑](#footnote-ref-2)
3. *See* US Internal Revenue Code of 1986 (as amended) section 401 et seq. [↑](#footnote-ref-3)
4. *See* Calpers, Current Investment Fund Values, at <http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/mvs.xml> (visited September 20, 2012). [↑](#footnote-ref-4)
5. “About TIAA CREF” at <https://www.tiaa-cref.org/public/about> (visited September 20, 2012). [↑](#footnote-ref-5)
6. *See* Part 3, *infra.* A sovereign wealth fund that also was a pension, profit sharing or stock bonus plan would not be taxed under the proposals described in this part or Part 3. [↑](#footnote-ref-6)
7. The Urban Institute, *Nonprofit Sector* at <http://www.urban.org/nonprofits/more.cfm> (visited September 11, 2012). [↑](#footnote-ref-7)
8. Id. [↑](#footnote-ref-8)
9. Id. [↑](#footnote-ref-9)
10. Independent Sector at <http://www.independentsector.org/economic_role> (visited September 11, 2012). [↑](#footnote-ref-10)
11. Many non-profit organizations are not profitable and are heavily dependent on volunteers to carry out their exempt activities. The Rotary Club, for example, is a non-profit organization that has over 1 million volunteers carrying on its various activities around the world. *See* Rotary International’s Federal Form 990 for 2010 at <http://www.rotary.org/RIdocuments/en_pdf/ri_irs_form990_fy11.pdf> (visited September 19, 2012). [↑](#footnote-ref-11)
12. In 2009, for example, the President of Drexel University was paid $4.9 million; the President of Johns Hopkins University was paid $3.8 million; and the President of the University of the Pacific was paid $2.4 million. See Executive Compensation at Private Universities at <http://chronicle.com/article/What-Private-College/129979/> (visited September 11, 2012). The CEO of the American Cancer Society was paid $2.2 million. American Institute of Philanthropy, *Top 25 Compensation Packages,* at[*http://www.charitywatch.org/hottopics/Top25.html*](http://www.charitywatch.org/hottopics/Top25.html)(Visited September 11, 2012) Their compensation was dwarfed by the University of Alabama’s football coach, Nick Saban. Coach Saban has a five year contract worth $45 million. *See* Nick Saban gets raise, extension, at <http://espn.go.com/college-football/story/_/id/7740227/alabama-crimson-tide-grant-coach-nick-saban-raise-2-year-extension> (visited September 11, 2012).

Working for mutual benefit associations also can be very profitable. Roger Goodell, the Commissioner of the National Football League, was paid $11.6 million for the fiscal year ending March 31, 2011. He was, however, only the second highest paid employee of the NFL. The highest paid was Steve Bornstein, the head of the NFL TV Network, who was paid $12.2 million. *See* <http://profootballtalk.nbcsports.com/2012/04/03/league-paid-goodell-11-6-million-nfl-network-head-12-2-million/> (visited September 29, 2012). [↑](#footnote-ref-12)
13. The profits of a non-profit charitable organization, for example, must be accumulated for future charitable purposes and when the charitable organization is wound up and liquidated, the accumulated assets of the organization must be transferred to another charitable organization or to a local, state, or national government entity. *See* Charity – Required Provisions for Governing Documents, at [http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Charity---Required-Provisions-for-Organizing-Documents](http://www.irs.gov/Charities-%26-Non-Profits/Charitable-Organizations/Charity---Required-Provisions-for-Organizing-Documents) (visited September 19, 2012). [↑](#footnote-ref-13)
14. Detailed financial information and the tax exempt status of most non-profit organizations and mutual benefit associations can be found in the federal form 990, which the US Government requires most tax exempt organizations to file annually. The form 990 for 2010 for the American Bar Association, for example, can be found at <http://www.americanbar.org/utility/about_the_aba/financial_reports.html> (visited September 14, 2012). Included on the form 990 are (i) the basis for tax exemption, (ii) investment income, (iii) unrelated business income, (iv) dues, subscriptions, and other income from exempt functions, and (v) compensation of the highest paid officers and employees.

Some organizations are explicitly created as for profit entities, even though they engage in what traditionally have been non-profit activities. Phoenix University, for example, is a popular, large,

on-line university that is organized as a for profit company. *See* [www.Phoenix.edu](http://www.Phoenix.edu) (visited October 1, 2012). [↑](#footnote-ref-14)
15. Non-profits and mutual benefit associations that qualify under IRC section 501(c) are generally exempt from the federal income tax. In the case of charitable, religious and educational organizations, the federal income tax exemption usually is accompanied by an exemption from any state and local income and property taxes. In addition, gifts to charitable, religious, and educational organizations qualify for a federal (and sometimes state) income tax deduction under IRC section 170. [↑](#footnote-ref-15)
16. All four of these organizations have substantial assets. According to the 2011 federal tax forms 990, the American Medical Association has assets of $355 million and the American Medical Foundation has assets of $20 million. The American Bar Association has assets of $275 million while the American Bar Foundation has assets of $20 million. [↑](#footnote-ref-16)
17. As its name implies, the US Treasury’s **Cumulative List of Exempt Organizations** contains an updated list of organizations that qualify under IRC section 501(c)**. The Cumulative List** also specifies which part of IRC section 501(c) each organization qualifies under so the general nature of each organization can be determined from a quick look at **The Cumulative List.** [↑](#footnote-ref-17)
18. *See* Bittker and Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation,* 85 **Yale Law Journal** 299 (1976), at p. 301(hereafter referred to as “Bittker”). [↑](#footnote-ref-18)
19. Id. [↑](#footnote-ref-19)
20. Id. [↑](#footnote-ref-20)
21. Id. at p. 354. [↑](#footnote-ref-21)
22. Id. at p. 354 – 355. [↑](#footnote-ref-22)
23. Id. at p 350 - 351. [↑](#footnote-ref-23)
24. Revenue Act of 1950, 64 Stat. 906. UBIT is currently codified as sections 511 - 514 of the IRC of 1986. [↑](#footnote-ref-24)
25. IRC section 511(a). [↑](#footnote-ref-25)
26. Although there was anecdotal evidence of instances where universities acquired for profit businesses, it was never demonstrated that the acquisitions lead to anticompetitive behavior. Bittker at p.318. [↑](#footnote-ref-26)
27. *See* Rev. Rul. 80 – 296, 1980 – 2 Cum. Bull. 195. [↑](#footnote-ref-27)
28. IRC section 513(i). [↑](#footnote-ref-28)
29. IRC section 512(a). [↑](#footnote-ref-29)
30. *See* Cowan, *Taxing and Regulating College and University Endowment Income: The Literature’s Perspective,* 34 **Journal of College and University Law** 509 (2008) at p. 520 (hereafter referred to as “Cowan”); Bittker at pp. 321 -22. [↑](#footnote-ref-30)
31. IRC section 512(b)(4). [↑](#footnote-ref-31)
32. IRC section 514(c). [↑](#footnote-ref-32)
33. Bittker at p. 321. [↑](#footnote-ref-33)
34. Id. [↑](#footnote-ref-34)
35. IRC section 4940. [↑](#footnote-ref-35)
36. *See* Private Foundation Excise Taxes at [http://www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Private-Foundation-Excise-Taxes](http://www.irs.gov/Charities-%26-Non-Profits/Private-Foundations/Private-Foundation-Excise-Taxes) (visited September 20, 2012). [↑](#footnote-ref-36)
37. Federal form 990. [↑](#footnote-ref-37)
38. Id. [↑](#footnote-ref-38)
39. Id. [↑](#footnote-ref-39)
40. *See* [http://www.irs.gov/Charities-&-Non-Profits/Other-Non-Profits/Tax-Issues-for-Tax-Exempt-Social-Clubs](http://www.irs.gov/Charities-%26-Non-Profits/Other-Non-Profits/Tax-Issues-for-Tax-Exempt-Social-Clubs) (visited October 1, 2012). [↑](#footnote-ref-40)
41. Id. [↑](#footnote-ref-41)
42. *See* <http://www.revenue.wi.gov/pubs/pb500.pdf> (visited October 1, 2012). [↑](#footnote-ref-42)
43. Id. [↑](#footnote-ref-43)
44. Universities and colleges, for example, are able to shield hundreds of millions of dollars in revenue from sporting events because the government has determined that sporting events are part of their educational program. *See* Rev. Rul. 80-296, 1980 – 2 Cum. Bull. 195; Cowan at p. 519. [↑](#footnote-ref-44)
45. Cowan at p. 534. [↑](#footnote-ref-45)
46. Id. [↑](#footnote-ref-46)
47. Id. at p. 536. [↑](#footnote-ref-47)
48. Id. [↑](#footnote-ref-48)
49. Id. at p. 535. [↑](#footnote-ref-49)
50. Bittker at p. 308. [↑](#footnote-ref-50)
51. Id. at p. 304. [↑](#footnote-ref-51)
52. Cowan at p. 543, quoting Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption,* 23 **Journal of Corporate Law** 585 (1998). [↑](#footnote-ref-52)
53. Bittker at p. 354. [↑](#footnote-ref-53)
54. Id. at p. 354 – 355. [↑](#footnote-ref-54)
55. Id. at p 350 - 351. [↑](#footnote-ref-55)
56. IRC section 512. [↑](#footnote-ref-56)
57. Bittker at p. 319. [↑](#footnote-ref-57)
58. Id. [↑](#footnote-ref-58)
59. Bittker at p. 319. [↑](#footnote-ref-59)
60. Id. [↑](#footnote-ref-60)
61. In 1989, for example, total college and university endowments were just over $100 billion, but by 2007 they had grown to $437 billion, although they then declined significantly due to the 2007 – 2008 financial crisis. GAO Report at p. 15, at http:// www.gao.gov/new.items/d10393.pdf (visited October 4, 2012) . [↑](#footnote-ref-61)
62. *See* <http://nces.ed.gov/fastfacts/display.asp?id=73> (visited October 3, 2012). [↑](#footnote-ref-62)
63. http://www.commonwealthfund.org/~/media/Files/Publications/Annual Report Essay/2009/Mar/New Financial Realities The Response of Private Foundations (visited October 3, 2012). [↑](#footnote-ref-63)
64. *See* <http://www.economist.com/node/21560536> (visited October 3, 2012). [↑](#footnote-ref-64)
65. <http://www.pbs.org/mormons/faqs/structure.html> (visited October 3, 2012). [↑](#footnote-ref-65)
66. Bittker at 318 – 320. [↑](#footnote-ref-66)
67. Bittker at pp. 318 – 319. [↑](#footnote-ref-67)
68. *See* [*http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPUBLICSECTORANDGOVERNANCE/EXTPUBLICFINANCE/0,,contentMDK:20233695~menuPK:1747624~pagePK:148956~piPK:216618~theSitePK:1339564~isCURL:Y,00.html*](http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPUBLICSECTORANDGOVERNANCE/EXTPUBLICFINANCE/0%2C%2CcontentMDK%3A20233695~menuPK%3A1747624~pagePK%3A148956~piPK%3A216618~theSitePK%3A1339564~isCURL%3AY%2C00.html) *(visited October 1, 2012).* [↑](#footnote-ref-68)
69. IRC section 585. [↑](#footnote-ref-69)
70. Homepage of the Sovereign Wealth Fund Institute at <http://www.swfinstitute.org/what-is-a-swf/> (visited September 20, 2012); *Also see* *Assets of sovereign wealth funds climb to record USD4.8 trillion in 2011 at* <http://www.hedgeweek.com/2012/02/02/161478/assets-sovereign-wealth-funds-climb-record-usd48-trillion-2011> (visited September 20, 2012); Sovereign wealth fund assets near $5 trillion at <http://www.efinancialnews.com/story/2012-02-01/sovereign-wealth-fund-industry-size>. [↑](#footnote-ref-70)
71. Joint Committee on Taxation, *Economic and US Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States* (June, 2008) at pp. 23 – 25, at [www.jct.gov](http://www.jct.gov) (hereafter referred to as “Joint Committee on Taxation”). [↑](#footnote-ref-71)
72. Joint Committee on Taxation at p. 24. [↑](#footnote-ref-72)
73. ABA Tax Section Annual Meeting*: Sovereign Wealth Funds: Tell Me More … and More*, at p. 10 (May, 2008). [↑](#footnote-ref-73)
74. *What should Europe do about sovereign wealth funds?* at <http://www.cer.org.uk/publications/archive/bulletin-article/2007/what-should-europe-do-about-sovereign-wealth-funds> (visited September 20, 2012). [↑](#footnote-ref-74)
75. OECD, *Sovereign Wealth Funds and Recipient Country Policies* at <http://www.oecd.org/investment/investmentpolicy/40408735.pdf>. [↑](#footnote-ref-75)
76. IMF, *International Working Group of Sovereign Wealth Funds is Established to facilitate Work on Voluntary Principles,* at [www.imf.org/external/np/sec/pr/2008/pr0897.htm](http://www.imf.org/external/np/sec/pr/2008/pr0897.htm) (2008). [↑](#footnote-ref-76)
77. Joint Committee on Taxation at p. 33, especially note 54. [↑](#footnote-ref-77)
78. Joint Committee on Taxation at pp. 22 – 23. [↑](#footnote-ref-78)
79. Joint Committee on Taxation at p. 22,see note 17. [↑](#footnote-ref-79)
80. Joint Committee on Taxation at p. 22, see notes 18 and 19. [↑](#footnote-ref-80)
81. See Sovereign Wealth Fund Institute (SWFI) homepage (<http://www.swfinstitute.org/what-is-a-swf/> (visited September 20, 2012)). [↑](#footnote-ref-81)
82. *See* <http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/mvs.xml> (as of October 3, 2012). [↑](#footnote-ref-82)
83. *See* <http://www.swib.state.wi.us/FY11_Annual.pdf> (as of June 30, 2011). [↑](#footnote-ref-83)
84. For a brief explanation of the differences, see <http://www.swfinstitute.org/research/investmentvehicles.php> (visited September 20, 2012) [↑](#footnote-ref-84)
85. *See generally* **International Income Taxation and Developing Countries** (UN Doc. ST/CTC/56, 1988). [↑](#footnote-ref-85)
86. If the foreign investor has a permanent establishment in the host country and the recurrent income is attributable to the permanent establishment, that income is taxed on a net basis in the same fashion as the other income of the permanent establishment. [↑](#footnote-ref-86)
87. US Internal Revenue Code of 1986 (as amended), sections 1441 and 1442. [↑](#footnote-ref-87)
88. See <http://www.hasil.org.my/goindex.php?kump=2&skum=6&posi=1&unit=5&sequ=1&cariw=witholding%20tax> and <http://www.hasil.org.my/pdf/pdfam/DoubleTaxationAgreementRates.pdf> (visited September 20, 2012). [↑](#footnote-ref-88)
89. Joint Committee on Taxation at p. A-9. Unfranked dividends are corporate distributions from profits on which the corporate tax has not been paid. Id., see note 12. [↑](#footnote-ref-89)
90. *See* <http://www.iras.gov.sg/irasHome/page04.aspx?id=410> (visited September 20, 2012). [↑](#footnote-ref-90)
91. *See* <http://www.iras.gov.sg/irasHome/page04.aspx?id=600> (visited September 20, 2012). The 18 percent withholding tax on management, technical service and service fees, however, is not a final tax. [↑](#footnote-ref-91)
92. Joint Committee on Taxation at A-37; *also see* <http://www.mizuhocbk.com/service/custody/pdf/11.pdf> (visited September 20, 2012). [↑](#footnote-ref-92)
93. *See* <http://www.iras.gov.sg/irasHome/page04.aspx?id=596> (visited September 20, 2012). [↑](#footnote-ref-93)
94. US Internal Revenue Code of 1986 (as amended) section 892. [↑](#footnote-ref-94)
95. ABA Tax Section Annual Meeting: *Sovereign Wealth Funds: Tell Me More … and More*, at p. 10 (May, 2008). [↑](#footnote-ref-95)
96. Australian Interpretative Decision 2002/45 at <http://law.ato.gov.au/atolaw/view.htm?dbwidetocone=05%3AATO%20Interpretative%20Decisions%3ABy%20Year%3A2002%3A1-99%3A%230045%23ATO%20ID%202002%2F45%20-%20Sovereign%20Immunity%3B> (visited September 20, 2012). [↑](#footnote-ref-96)
97. Joint Committee on Taxation at p. A-9, note 17. [↑](#footnote-ref-97)
98. HM Revenue and Customs, INTM155010 – *Sovereign and Crown Immunity,* <http://www.hmrc.gov.uk/manuals/intmanual/INTM155010.htm> (visited September 20, 2012). Joint Committee on Taxation at A-49. [↑](#footnote-ref-98)
99. *See* <http://www.cra-arc.gc.ca/E/pub/tp/ic77-16r4/ic77-16r4-e.txt> (visited September 20, 2012). [↑](#footnote-ref-99)
100. *See* <http://www.iras.gov.sg/irasHome/uploadedFiles/Quick_Links/newsingaporemalaysiadta13feb2006.pdf> (visited September 20, 2012). [↑](#footnote-ref-100)
101. *See* <http://www.iras.gov.sg/irasHome/uploadedFiles/Quick_Links/singaporejapandta.pdf> (visited September 20, 2012) and <http://www.regjeringen.no/en/dep/fin/Selected-topics/taxes-and-duties/skatteavtaler/Convention-Norway---Russia.html?id=636875> (visited September 20, 2012). [↑](#footnote-ref-101)
102. *See* <http://www.irs.gov/pub/irs-trty/denmarkprot06.pdf> (visited September 20, 2012). [↑](#footnote-ref-102)
103. *See* <http://www.irs.gov/pub/irs-trty/denmark2.pdf> (visited September 20, 2012). [↑](#footnote-ref-103)
104. *See* <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teswiss.pdf> (visited September 20, 2012) and <http://www.irs.gov/pub/irs-trty/nether.pdf> (visited September 20, 2012). [↑](#footnote-ref-104)
105. Joint Committee on Taxation at A-30. [↑](#footnote-ref-105)
106. *See* <http://www.fms.treas.gov/annualreport/cs2011/finhigh.pdf> (visited October 4, 2012). [↑](#footnote-ref-106)
107. *See Economic and Financial Indicators*, **The Economist** (US edition) at p. 84 (September 15, 2012). [↑](#footnote-ref-107)
108. The US is not alone with gigantic government deficits. As a percentage of their GDP, both the UK and Japan have deficits that are greater than the US deficit. Id. [↑](#footnote-ref-108)