NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON
SECTION 514: DEBT-FINANCED INCOME SUBJECT TO UBIT

AUGUST 12, 2010

In 1969, Congress amended Section 514 of the Internal Revenue Code (the "Code")[1] to make the debt-financed investment income of tax-exempt organizations generally subject to the unrelated business income tax ("UBIT").[2] In 1980, Congress created an exception for pension plans which invest in debt-financed real estate; in 1984 this exception was extended to schools. In recent years, several proposals have come before Congress to exclude from the Section 514 UBIT rules partnership income allocated to tax-exempt organizations where the partnership itself has debt-financed investments in securities and commodities.[3]

Over 40 years have passed since Congress enacted the broad-based debt-financed UBIT rules. We recommend that Congress, together with Treasury, undertake a ground-up review of Section 514. In such a review, we would recommend that Congress and Treasury consider the extent to which appropriate tax policy goals are being furthered by a continuation of the debt-financed income rules, and the various exceptions to those rules, in their current form.[4]

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1 Unless otherwise noted, all Section references herein are to the Internal Revenue Code of 1986, as amended or the regulations promulgated thereunder.

2 This report was prepared by an *ad hoc* committee of the Tax Section of the New York State Bar Association. The principal drafters of this report were Richard R. Upton and Douglas R. McFadyen, with substantial assistance from Peter Blessing, David Miller, Kim Blanchard, Elizabeth Kessenides, Ansgar Simon and Matthew Kohley. Helpful comments were received from Andrew Braiterman, James Brown, William Burke, Peter Canellos, Bob Cassanos, Dahlia Doumar, Andrew Needham, Erika Nijenhuis, Deborah Paul, Joel Scharfstein, Michael Schler, Jodi Schwarz and Eric Sloan.

3 H.R. 3497 was introduced in the House of Representatives on July 31, 2009 and, subsequently, referred to the Committee on Ways and Means. A similar amendment had been proposed in 2007 as section 612 of H.R. 3996, the "Temporary Tax Relief Act" of 2007, but was not included in the final "Tax Increase and Prevention Act" of 2007.

4 We and others have previously commented on a need for simplification of the debt-financed income rules. *See* New York State Bar Association (NYSBA) Tax Section, "Report on *Notice 90-41* and Certain Other Issues Arising Under Section 514(c)(9) of the Internal Revenue Code Relating to Debt Financed Real Estate Investment by Tax Exempt Organizations," *Tax Notes*, May 27, 1991, p. 1057; NYSBA Tax Section, "Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations" (Feb. 14, 1997), Doc. 97-4841 (33 pages), 97 TNT 34-39 at 20 ("we believe that the application of Section 514 to leveraged real estate partnerships can be made reasonably workable only be amending the flawed statute."); NYSBA Tax Section, "Report on Simplification of the *Internal Revenue Code*," at 13-14 (Mar. 18, 2002), Doc 2002-6800 (25 pages), 2002 TNT 54-48 (recommending an amendment

This report recommends that the debt-financed income rules be revisited in light of the over 40 years of experience with the rules since enactment in 1969, changes in circumstances occasioned by other statutory and regulatory tax provisions, changes in institutional investment practices, and changes in the global investment environment. Congress ultimately may determine, for example, that the unique status of tax exempt organizations justifies certain disincentives in relation to leveraged investments in assets that are not related to the exempt purpose of an organizations, or that the revenue costs of a wholesale change may be unacceptable in the current legislative environment. In such case, we encourage Congress to consider revisions that would better target the provisions to address the perceived policy considerations and consider exemptions for certain types of transactions, or by certain types of tax-exempts, where appropriate. For example, the policies and revenue impact of exempting some, but not all, exempt organizations from application of the UBIT rules to investments in debt-financed real estate could be revisited. Further, we suggest that Congress consider a broad-based exception to Section 514 for debt-financed investments in securities and commodities.

The fundamental tax policy question is whether it is appropriate to apply UBIT to any or all routine investments made by tax exempts where some form of leverage is utilized. For example, are the distinctions between organizations eligible for exemption from UBIT on debt-financed real estate, generally pension plans and schools, and those not so eligible, including public charities, private foundations and churches, warranted? Should UBIT apply to

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to Section 514(c)(9)(E) to permit partnership allocations that do not have a principal purpose of tax avoidance); Arthur A. Feder and Joel Scharfstein, "Leveraged Investment in Real Property Through Partnership by Tax Exempt Organization After the Revenue Act of 1987 – A Lesson in How the Legislative Process Should Not Work," 42 Tax Lawyer *55* (1988); William H. Weigel, "Unrelated Debt-Financed Income Under Section 514: A Retrospective (and a Modest Proposal)," 50 Tax Lawyer 625, 658 ("Section 514 should be repealed.") ("Weigel").

debt-financed income from securities and commodities? Should it matter whether debt-financed investments are held directly or through a partnership? Would safeguards be needed to avoid abusive transactions if Section 514 were scaled back or repealed?

Under current law, the investment practices and portfolios of exempt organizations are inevitably affected by the debt-financed income rules. As discussed below, Section 514 often can be avoided by structures or transactions that essentially are economically equivalent to transactions taxed under Section 514. The ability to structure around Section 514 places a premium on tax planning and raises fairness issues for organizations not large enough or sophisticated enough to engage in such planning.

At the same time, as a policy matter the status of exempt organizations as tax exempt raises unique considerations: considerations regarding whether certain investment activities justify maintaining disincentives under the Code on the basis that, for example, the increased volume of investment activity may detract from the entity's mission, overly expand the tax-exempt sector, or result in a revenue loss that is net of correlative tax revenue effects or to a greater extent than any corresponding alleviation of pressure on tax expenditures.

If, following a review of Section 514, Congress were to determine to maintain the debt-financed income rules in whole or in part, because of revenue concerns or other policy considerations, it may wish to consider whether changes might be appropriate to clarify the extent to which the rules apply to structures and transactions that either have limited economic substance or otherwise essentially are economically equivalent to structures and transactions which are taxable.

This report discusses only the debt-financed income rules of Section 514. We do not address or question the ongoing importance of the UBIT rules generally (Sections 511-513).[5]

I. Background

A. Overview of Debt-financed Income Rules

1. UBIT in General

An organization otherwise exempt from federal income tax is nonetheless taxed on its unrelated business taxable income ("UBTI"), generally at corporate tax rates of up to 35%.[6] UBTI is defined as gross income derived from an unrelated trade or business (within the meaning of Section 513) regularly carried on by the tax-exempt organization (net of any attributable deductions). Such tax-exempt organizations include organizations with an educational purpose, like colleges and universities, charities (both public philanthropic organizations and private foundations) and pension funds within the meaning of Section 401. Expressly excluded from UBTI, among other categories of income, are the following items of generally passive income:

- dividends, interest, royalties, payments with respect to securities loans, annuities, income from notional principal contracts, and amounts received or accrued as consideration for entering into agreements to make loans;
- rents from real property or personal property leased with real property, if the amount of rent attributable to the personal property is an incidental amount in

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[5] *See generally* Daniel Halperin, "The Unrelated Business Income Tax and Payments From Controlled Entities," *Tax Notes*, Dec. 12, 2005, p. 1443, Doc 2005-24023, or 2005 TNT 238-27; Henry B. Hansmann, "Unfair Competition and the Unrelated Business Income Tax," 75 Va. L. Rev. 605 (1989) ("Hansmann"); Calvin H. Johnson and Ellen P. Aprill, "UBIT to the Defense! ESOPs and Government Entities," Tax Notes, July 19, 2010, p. 317 ("Johnson and Aprill").

[6] However, charitable trusts use the rates in Section 1(e) applicable to trusts. Thus, a charitable trust pays UBIT on its ordinary income at rates up to 35% and pays UBIT on its debt-financed capital gains generally at a 15% rate.

relation to the total rent, provided that (i) not more than 50 percent of the rent is attributable to the personal property and (ii) the amount of rent does not depend in whole or in part on income or profits (other than a percentage of receipts or sales) derived by any person from the property; and

- gains from property other than inventory or other property primarily held for sale to customers in the ordinary course of business.

2. Debt-Financed Income Rules

Under Section 512(b)(4), however, UBTI generally is deemed to include gross income from debt-financed property to the extent attributable to the "acquisition indebtedness" incurred or continued in respect of such property. Acquisition indebtedness is defined in Section 514(c) as the unpaid amount of indebtedness incurred (i) in acquiring or improving the relevant property, (ii) in anticipation of the acquisition or improvement of the property or (iii) after the acquisition or improvement of the property if the indebtedness would not have been occurred but for, and was reasonably foreseeable at the time of, the acquisition or improvement. Pursuant to Section 514(c)(4), acquisition indebtedness does not, however, generally include indebtedness the incurrence of which is "inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption." As an example of indebtedness inherent in the tax-exempt purpose or function, the Code cites the taking of deposits by a tax-exempt credit union. Another example is debt-financed investments in employer securities by an employee stock ownership plan ("ESOP").[7] Additionally, under Section 514(b)(1)(A)(i), debt-financed property generally does not include "property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise

[7] Rev. Rul. 79-122, 1979-1 C.B. 204.

or performance . . . of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501." The gross income from debt-financed property attributable to acquisition indebtedness is a fraction (expressed as a percentage) of the gross income from the property equal to the average acquisition indebtedness for that taxable year divided by the average adjusted basis of such property (but in no event more than 100 percent). If the debt-financed property is disposed of, the taxable gain is based on the highest amount of acquisition indebtedness during the 12-month period ending with the date of such disposition.[8]

For example, securities bought on margin generally will give rise to taxable UBTI.[9] Moreover, for its holding of securities, a tax-exempt organization generally cannot avail itself of the exception to acquisition indebtedness for indebtedness "inherent" in the performance or exercise of an organization's tax-exempt purpose or function or the exception for property substantially used in a manner substantially related to the tax-exempt purpose or function (other than the need to generate income). Further, if a partnership incurs acquisition indebtedness, a partner that is a tax-exempt organization generally will be treated as incurring its attributable share of the acquisition indebtedness.[10]

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[8] Technically, Section 514 applies to any tax-exempt organization, including foreign charitable organizations. Section 1443 provides for withholding on the UBTI of foreign tax-exempt organizations. We understand that withholding agents, as well as foreign exempt organizations, generally do not consider whether the U.S. investment was acquired with borrowed money and accordingly would generate UBTI subject to withholding.

[9] *See, e.g., Henry E. and Nancy Horton Bartels Trust for the Benefit of Cornell University v. United States*, 88 Fed.Cl. 105 (Fed. Cl. 2009); *Henry E. and Nancy Horton Bartels Trust v. United States*, 209 F.3d 147 (2d Cir. 2009), *cert. denied*, 531 U.S. 978 (2000).

[10] Rev. Rul. 74-197, 1974-1 C.B. 143; *See* Section 512(c)(1). *See also*, PLRs 9703026, 9651001 and 9533014.

B. Legislative History and Background[11]

1. Business Income and Debt-Financed Income Prior to 1950

Until the introduction of UBIT in 1950, tax-exempt organizations enjoyed a full exemption from federal income tax. [12] One common practice of exempt organizations in years before 1950 was to engage in sale-leaseback transactions in which a tax-exempt organization would purchase real property entirely with seller provided financing, lease the property back to the seller under a long-term lease, and service the loan with tax-free rental income from the lease.[13]

2. Revenue Act of 1950

As a response both to exempt organizations engaging in for-profit businesses and sale-leaseback transactions, in the Revenue Act of 1950 (the "1950 Act"), Congress subjected charitable organizations (not including churches) and certain other exempt organizations to tax on their unrelated business income.[14] The legislative history to the 1950 Act provides "the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition."[15] Congress excluded from the tax certain passive forms of income, concluding

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[11] Much of this legislative history is found in the Joint Committee on Taxation Report entitled "Present Law and Analysis Relating to Selected International Tax Issues" September 24, 2007 (including discussions of a proposed exemption from Section 514 for debt-financed securities).

[12] For example, in a famous case, a macaroni company owned for the benefit of New York University School of Law was found to be exempt from tax. *C.F. Mueller Co. v. Comm.*, 190 F.2d 120 (3rd Cir. 1951), rev'g 14 T.C. 922 (1950).

[13] H.R. Rep. No. 2319, 81st Cong. 2d Sess. 38-39 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess 31-32 (1950).

[14] Revenue Act of 1950, Pub. L. No. 81-814, Section 301. In 1951, Congress extended the unrelated business income tax to the income of state colleges and universities. Section 511(a)(2)(B).

[15] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950), S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). The Supreme Court has stated that the "undisputed purpose" of the unrelated business income tax is "to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed." *United States v. American Bar Endowment,* 477 U.S. 105, 114 (1986*); See also, United States v. American College of Physicians,* 475 U.S. 834, 838 (1986) ("Congress perceived a need to restrain the unfair competition fostered by the tax laws").

that such passive income was "not likely to result in serious competition for taxable businesses having similar income"[16] and "should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations."[17]

The 1950 Act also taxed as UBTI certain rents received in connection with the leveraged sale and leaseback of real estate.[18] Congress cited three objections to such transactions: (1) "the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption since the only contribution it makes to the sale and lease is the tax exemption"; (2) unchecked, such transactions could result in exempt organizations owning "the great bulk of the commercial and industrial real estate in the country…lower[ing] drastically the rental income included in the corporate and individual income tax bases"; and (3) the "possibility…that the exempt organization has in effect sold part of its exemption…by…paying a higher price for the property or by charging lower rentals than a taxable business could charge."[19] This provision was a precursor to the present-law tax on unrelated debt-financed income.

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[16] S. Rep. No. 2375 81st Cong., 2d Sess. 30-31 (1950).

[17] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 31 (1950).

[18] For taxable years beginning after December 31, 1950, the 1939 Internal Revenue Code therefore treated as UBTI rents relating to a so-called "supplement U lease." Such a supplement U lease had to be for a period of more than five years (including any options for renewal or extension) of real property subject to acquisition indebtedness. A lease of personal property was treated as a supplement U lease if made under, or in connection with, the lease of real estate. Section 423 (1951). (These sections were renumbered to their current numbering system as a result of the enactment of the 1954 Code.) The 1950 Act limited UBTI to longer term leases, limited the scope of personal property subject to the UBTI rules and specifically excluded churches from the tax-exempt organizations subject to the new UBTI rules. Thus, sale-leaseback transactions could still be done after 1950, if not with a church, then by entering into a lease with a term of five years or less.

[19] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38-39 (1950), S. Rep. No. 2375, 81st Cong. 2d Sess. 31-32 (1950).

3. The Tax Reform Act of 1969

a. What led to the 1969 Act: *Clay Brown*[20] and Similar Cases

Despite the sale-leaseback provisions of the 1950 Act, tax exempts continued to enter into seller financed sale leaseback transactions that the IRS considered abusive. For example, through 1951, a single tax-exempt organization, University Hill Foundation, entered into 24 such sale-leaseback transactions, which were commonly referred to as "Cote formula" transactions.[21] In Rev. Rul. 54-420,[22] the IRS announced its attack on Cote formula transactions by, *inter alia*, asserting that organizations engaging in such transactions would not be considered engaged *exclusively* in activities with a tax-exempt function or purpose. Despite Rev. Rul. 54-420, a 1963 *Journal of Taxation* article advised on how to structure a Cote formula transaction, which it claimed "has long been recognized as an advantageous tax-saving transaction ... [a]lthough IRS opposition as to the validity of the sale will sometimes be encountered."[23] The validity of these transactions ultimately was litigated in *Clay Brown.*[24]

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20 *Commissioner v. Brown*, 380 U.S. 563, 85 S.Ct. 1162 (1965), *aff'g* 325 F.2d 313 (9th Cir. 1963) ("*Clay Brown*").

21 *See University Hill Foundation v. Commissioner*, 446 F.2d 701 (9th Cir. 1971), rev'g 51 T.C. 548 (1969). These transactions were structured by the Foundation's president, an attorney named Paul Cote, who apparently was the first to design transactions using the 80/90 formula present in *Clay Brown* (discussed below).

22 1954-2 C.B. 128, *obs.*, Rev. Rul. 77-278, 1977-2 C.B. 485.

23 *New Developments in Tax-Exempt Institutions*, 19 J.Tax'n 302.

24 The Supreme Court did not have to address the position advanced in Rev. Rul. 54-420 in *Clay Brown* because the treatment of the seller, and not of the tax-exempt entity, was at issue in that case. By contrast, in the *University Hill Foundation* case, the Appeals Court of the Ninth Circuit sided with the Commissioner and concluded that the University Hill Foundation did not operate "exclusively for exempt purposes." But this success had to wait until 1971 and involved a more egregious case than those involving one-off Cote formula transactions, which frequently passed judicial muster. *See, e.g., Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F.Supp. 899 (Ct.Cl. 1956). *See also, Shiffman v. Comm'r*, 32 TC 1073 (1959) (organization operated exclusively for charitable purposes even though substantially all of the income used to make payments on notes issued in bootstrap acquisition); *Ohio Furnace Co., Inc. v. Comm'r*, 25 TC 179 (1955) (same for educational organization). *Cf. Comm'r v. Leon Beeghly Fund*, 310 F.2d 756 (6th Cir. 1962) (use of funds to pay stock purchase price at a later time did not violate requirement that funds had to be "permanently set aside" for charitable purposes).

In *Clay Brown*, a tax-exempt organization purchased all of the stock of a privately held corporation without using any of its own funds for the purchase. The sole consideration for the stock was a non-recourse, non-interest bearing, ten-year note. The tax-exempt purchaser liquidated the corporation and entered into a five-year lease of all of the corporation's assets to a newly formed corporation, which was owned by persons technically unrelated to the selling shareholders and whose president was Mr. Clay Brown. The newly formed corporation was obligated to make lease payments equal to 80% of its net income (without regard to the lease payments) to the tax-exempt organization, and the tax-exempt organization in turn paid an amount equal to 90% of the lease payments it received, up to the fixed amount, as principal on the non-recourse note. Thus, the former shareholders of the old corporation received, in effect, 72% of the net profits realized from the assets (up to a fixed amount), but characterized such receipt as capital gain from the disposition of shares. Until the non-recourse note was satisfied, the tax-exempt organization essentially retained, tax-free, 8% of the profits derived from the assets of the old corporation. Once the non-recourse note was paid, it retained all of the income from the assets.[25] The Supreme Court upheld Mr. Brown's treatment of the proceeds received from the sale of the old corporation's stock as capital gains.[26]

b. Congress Enacts Broad-based Debt-financed Income Rules

In response to *Clay Brown*, the Tax Reform Act of 1969 (the "1969 Act") expanded the tax debt-financed income rules.[27] As *Clay Brown* demonstrated, the 1950 Act

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25 The actual facts are somewhat more complicated. Three years after the original sale and lease, the business fell on hard times and the note went into default; the business was sold for less than 25 percent of the original purchase price.

26 It is worth noting that the transaction in *Clay Brown* took place in a very different tax rate environment. In 1953, the year of the *Clay Brown* transaction, the corporate tax rate was 48 percent and, for individuals, the maximum marginal rate on ordinary income was 92 percent while the rate on capital gains was 25 percent.

27 In addition, in the 1969 Act, Congress extended UBIT to all exempt organizations described in Section 501(c) and 401(a) (except United States instrumentalities). We note the UBIT rules do not apply to ESOPs holding

provision that taxed income from certain leveraged sale-leaseback transactions had proved ineffective because taxpayers successfully structured transactions beyond the reach of the statute.[28] The expansion of Section 514 was motivated by a desire to eliminate abusive sale-leaseback transactions such as the one litigated in *Clay Brown*. In fact, the House Report refers to the amendments as "The Clay-Brown Provisions" and the Senate Report refers to them similarly as "The 'Clay Brown' provision or Debt-financed Property."[29]

However, it was widely recognized that the bills that led up to the 1969 Act, even if aimed at *Clay Brown*-type transactions, went well beyond merely preventing the result in *Clay Brown*. In 1966, the House of Representatives' Ways and Means Committee held extensive hearings on the issue, and witnesses testified on the scope of the bill. For example, the New York State Bar Association submitted draft legislation that would limit the tax to a percentage of the income from property acquired in a debt-financed transaction where the retirement of the debt was not determinable in advance (i.e., contingent on the earnings of the acquired property), or the tax-exempt's property was operated by another entity but would earn UBTI if operated directly.[30] A representative of the Bar Association testified on the "unreasonable and inequitable" aspects of the proposed legislation, pointing out that it would impose tax on the American National Red Cross if it borrowed funds to buy General Motors stock:

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employer S corporation stock or to pension funds supporting state and local governmental employees and other governmental affiliates. *See*, Johnson and Aprill at footnote 5 and Ellen P. Aprill, "Excluding the income of State and Local Governments: The Need for Congressional Action," 26 *Ga. L. Rev.* 421 (1992).

[28] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1969 (JCS-1670), December 3, 1970, at 62.

[29] H.R. Rep. 91-413, 91st Cong., 1st Sess., reprinted at 1969-3 C.B. 200, 229; S. Rep. 91-552, 91st Cong., 1st Sess., reprinted at 1969-3 C.B. 423, 464.

[30] House of Representatives, Committee on Ways and Means, Unrelated Debt-Financed Income of Tax-Exempt Organizations, Hearing Before the Committee on Ways and Means 42 (August 29, 1966) ("1966 Hearing").

> It is felt that this approach goes far beyond what is required in order to eliminate the Clay Brown abuse. What we have here is a technique which penalizes borrowing, as such, by exempt organizations, even if it is solely for the purpose of acquiring the most passive of investments.[31]

With full knowledge of these concerns, Congress passed the 1969 Act and expanded the debt-financed income rules to encompass all debt-financed investments.[32]

Since the enactment of the 1969 Act, Congress has had several opportunities to revisit these rules. In 1980, pension plans and the real estate community argued before Congress that pension plans should be able to invest without tax in group trusts acting on behalf of at least ten pension plans to diversify to assets outside of the volatile stock and bond markets and as a hedge against inflation.[33] Treasury voiced concern over creating a narrow exception to the debt-financed rules that would not be policy based:

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[31] 1966 Hearing at 43. The Section provided the following example:

> Thus, for example, if 100 shares of General Motors stock were acquired by the American National Red Cross for $10,000, $3,000 (or 30 percent) of which was borrowed from a bank, out of the $500 of annual dividend income earned, $150 (or 30 percent) would be fully taxable. Compare this with the mere $75 (or 15 percent) that a profit making corporation would be taxed upon in the same situation because of the operation of the 85 percent dividends received deduction which, for unexplained reason,, would not be available to exempt organization under this proposal. Further, if that stock were sold 2 years later by the Red Cross for $15,000, or $1,500 (or 30 percent) of its $5,000 gain would be subject to tax.
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> The above example illustrates the most unreasonable and inequitable aspect of the proposed legislation... It is felt that this approach goes far beyond what is required to eliminate the Clay-Brown abuse. What we have here is a technique which penalizes acquiring the most passive of investments...

Statement of Stanley S. Withhorn, New York State Bar Association (Tax Section, Committee on Exempt Organizations).

[32] In addition, in the 1969 Act, Congress extended UBIT to all exempt organizations described in Section 501(c) and 401(a) (except United States instrumentalities).

[33] Miscellaneous Tax Bills V: Hearings Before the Subcomm. on Taxation and Debt Management Generally of the S. Finance Comm., 96th Cong. 269, 314 (statement of Thomas J. Goldberg, President, Smith Barney Real Estate Corp.) ("1980 Hearings"); 1980 Hearings at 295, 316 (statement of Daniel I. Halperin, Deputy Assistant Secretary of Treasury).

> The real question for [Congress] to consider is whether we want to tax the income that pension funds earn on leveraged real estate investments. We see good arguments why the answer to that question is no, and if the answer is no, we ought to take a broad approach and not continue to proliferate narrow exceptions.[34]

Congress accepted this argument by broadening the pension plans' proposal and enacting Section 514(c)(9). In 1984, Congress again had the opportunity to reexamine Section 514 when educational institutions sought to have Section 514(c)(9) expanded to cover them. Treasury again resisted what it referred to as the "piecemeal repeal" of Section 514.[35] Congress, however, enacted only a narrow exception, rather than more broadly reconsidering Section 514.

C. Most *Clay Brown*-type Abuses are Prevented by Tax Law Provisions (outside Section 514)

The abuse in *Clay Brown* and other similar Cote formula transactions was not the tax-exempt organization's leveraged investment. Rather, the abuse lay in the fact that amounts that would have been taxed as ordinary income of the corporation that operated the business were converted into capital gain of the taxable seller. The interposition of a tax-exempt organization in the structure made this possible. The key to the abuse was the ability of the corporation that was operating the business to make deductible rental payments to a tax-exempt organization which was indifferent to receiving income because it was exempt from taxation. The exempt organization was then able to repay substantially all of such rental income back to the seller without tax detriment. As noted in the legislative history to the 1950 Act, Congress perceived this as the tax-exempt organization trading on its tax exemption.

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[34] 1980 Hearings at 316 (statement of Daniel I. Halperin, Deputy Assistant Secretary of Treasury).

[35] 1981-82 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 before the Subcomm. On Taxation and Debt Management of the Senate Finance Comm., 97th Cong., 2d Sess. 55 (1982) (statement of William McKee, Tax Legislative Counsel, Department of the Treasury) ("1982 Hearing").

Consistent with this, Congress, in its broader attack on *Clay Brown* and other Cote formula transactions under the 1969 Act, characterized income from various leasing transactions as UBTI regardless of whether they involved debt-financed property. Under Section 512(b)(3)(B)(ii), UBTI includes rents determined in whole or in part based on the income or profits derived by any person from the property leased (unless the amount is based on one or more fixed percentages of receipts or sales). In addition, under Section 512(b)(3)(B)(i), rental income derived from personal property leased with real property is excluded from the non-UBTI safe harbor (and in effect made taxable) if more than 50 percent of the total rent under the lease is attributable to personal property; if rents from personal property leased with real property are not incidental (10% or less), but are 50% or less of the total rent, the percentage of the rent representing rents from personal property is likewise excluded from the safe harbor.[36] Accordingly, subsequent to the 1969 Act, it is Section 512(b)(3)(B), not Section 514, that generally stops a tax-exempt organization from "trading" on its exemption through sale-leaseback transactions.[37]

The Code has changed dramatically since *Clay Brown*.[38] Even if Section 514 were completely repealed, the *Clay Brown* transaction could be not implemented today in a tax-efficient manner. In *Clay Brown*, the exempt organization purchased a corporation for a non-recourse, non-interest bearing note, liquidated the corporation without tax and leased the assets to a new corporation for rent equal to 80% of the operation's profit (before depreciation and

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[36] The 1969 Act removed from the 1950 Act definitions of taxable leases both the conditions that the leases be for a term longer than five years and that they be debt-financed.

[37] However, leases where rents are measured by discrete items of gross income can be structured to approximate rents measured by profits. In the absence of Section 514 or an anti-abuse rule, sale leaseback transactions of real estate could be structured in a way that could be perceived as abusive.

[38] See footnote 26. The tax rates today are very different from the rate environment in 1953, when very high tax rates on ordinary income and low rates on capital gains gave rise to both the incentive, and potential, for avoidance transactions that does not exist today.

taxes) and paid 90% of such rents to the seller as payments on the purchase money note. Today, under Section 336 the liquidation of the corporation would be taxable (though assets might instead by purchased from a seller that would not incur corporate tax), under Section 1274(e) the note would have imputed interest equal to 110% of the applicable federal rate and under Section 512(b)(3)(B)(ii) the organization's rental income would be subject to UBIT because it was based on the lessee's income or profits or, even if fixed rent, the personal property rents generally would be taxable.

D. Scope of Section 514 Today

In considering the Section 514 rules, it is important to understand their scope and breadth. The income and gains from any and all investment assets held by a tax-exempt organization which are subject to acquisition indebtedness are subject to UBIT, unless an exception (discussed below) applies. Thus, any investment generating interest, dividends, rents, royalties, capital gains, etc. potentially is subject to UBIT. Taxable investments include those purchased directly by the exempt organization with borrowed money, as well as investments subject to acquisition indebtedness which were contributed to the organization. Taxable investments include assets held directly and assets held through partnerships. It is not clear in the legislative history to Section 514 why Congress wrote Section 514 so broadly. The only abuse discussed in the legislative history to the 1969 Act was a desire to eliminate *Clay Brown*-type transactions. It could be speculated that Congress, frustrated by the holes in the 1950 Act, intentionally drafted the statute to be overinclusive to be certain that the *Clay Brown* abuses would never again reappear.

E. Formalistic Distinctions: Exceptions to Section 514 and Economically Similar Transactions Not Covered by Section 514

It has been widely noted that many transactions that use debt or leverage are

excepted by the statute, regulations or rulings from being subject to UBIT.[39] Further, well advised tax exempts often can structure transactions that are not subject to Section 514 but are economically equivalent to taxable transactions. The distinctions between taxable debt-financed investments subject to UBIT and those not subject to UBIT are seemingly arbitrary and, in many if not most cases, lacking in policy rationale.

1. Exceptions in the Statute

a. The Real Property Exception

Perhaps the most obvious exception from Section 514 is Section 514(c)(9), which exempts from Section 514 debt-financed real estate held by qualified organizations, principally pension plans and schools.[40] When this exception was first enacted as part of the Miscellaneous Revenue Act of 1980, it applied only to certain real property investments by qualified pension trusts.[41] Congress believed that such an exception was warranted because "the exception for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose – the payment of employee benefits."[42] Real estate investments are attractive "for diversification and to offset inflation. Debt financing is common in real estate investments." In addition,

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[39] *See* Suzanne Ross McDowell, "Taxation of Unrelated Debt-Financed Income," 34 Exempt Organization Tax Review 197 (Nov. 2001), available at 2002 TNT 48-52 ("McDowell").

[40] For purposes of this exception, a "qualified organization" is (i) an educational organization described in Section 170(b)(1)(A)(ii) and its affiliated supporting organizations; (ii) a qualified trust described in Section 401(a) (i.e., a "pension fund"); (iii) a title holding company described in Section 501(c)(25); or (iv) a retirement income account described in Section 403(b)(9).

[41] The exception did not apply, however, if any of five situations were present: (1) the acquisition price is not a fixed amount on the acquisition date; (2) the amount of indebtedness is dependent on the revenue, income, or profits derived from the debt-financed property; (3) the property is leased back to the seller (or a related party); (4) the property is acquired from or leased to a related person of the trust; and (5) the seller or person related to the trust provides nonrecourse financing, and the debt is subordinate to any other indebtedness on the property or the debt bore an interest rate significantly lower than that provided by unrelated parties. *Compare* Section 514(c)(9)(B)(i)-(v).

[42] S. Rep. No. 96-1036, 96th Cong., 2d Sess. 29 (1980).

Congress believed the exception provided to pension trusts was appropriate because, unlike the tax exemption for other organizations, the tax exemption for qualified trusts generally resulted only in deferral of tax; that is, the income from the trust would be taxed when distributed by the trust to individual recipients. Congress also believed that the five limitations placed upon use of the exception would "eliminate the most egregious abuses addressed by the 1969 legislation."

In the Deficit Reduction Act of 1984, Congress extended the real property exception to educational organizations, even though Treasury was opposed to this extension.[43] At the same time, Congress layered on additional conditions to the exception, including an absolute bar on seller financing and an anti-abuse rule in the case of qualified organizations that were partners in partnerships investing in debt-financed real property.[44] Congress believed the new restrictions were needed because prior law was "inadequate to prevent the shifting of tax benefits between tax-exempt organizations and taxable entities."[45]

We understand Congress enacted section 514(c)(9)(E) (the fractions rule) because it was concerned about transactions where taxable and tax exempt partners joined together in partnerships to own real estate and special allocations were included in the partnership agreements to benefit the taxable partners. The goal of the allocations was to give the taxable

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[43] 1982 Hearing at 53.

[44] Between 1986 and 1988, Congress introduced and modified rules requiring that investments through a partnership satisfy a prohibition on disproportionate allocations, i.e., the requirements that each partnership allocation have substantive economic effect and that the partnership satisfy the "fractions rule." Section 514(c)(9)(B)(vi) and (E).

In 1993, Congress relaxed some of the conditions required to meet the real property exception. In general, leasebacks to the seller (or a disqualified person) are allowed if no more than 25 percent of the leasable floor space in a building is leased back and the lease is on commercially reasonable terms. Section 514(c)(9)(G)(i). Seller financing is permitted if the financing is on commercially reasonable terms. Section 514(c)(9)(G)(ii). In addition, the fixed price restriction and the requirement that indebtedness not be paid out of revenue, income, or profits of the acquired property are relaxed for certain sales by financial institutions. Section 514(c)(9)(H).

[45] Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84), December 31, 1984, at 1151. In the Tax Reform Act of 1986, Congress provided exempt status for certain title holding companies (Section 501(c)(25)) and at the same time extended the real property exception to such companies.

partners losses (or less income) upfront and then reverse the allocations in later years. The allocations were designed to withstand challenge under the Section 704(b) substantial economic effect regulations as in effect at that time, which were relatively ineffectual in this regard as compared with those currently in effect. The tax exempts were given a better economic deal for use of their tax exemption.

While this type of transaction could be effected without leverage, its benefits were much more pronounced in a highly leveraged context and real estate generally could sustain substantial leverage. Since the addition of the fractions rule, Section 168(h) has been added to the Code (tax-exempt use property) and in particular Section 168(h)(6) (property owned by partnerships). This section cuts down the potential benefits of special allocations through partnerships by slowing down the partnership's depreciation, but it does not have all that much effect on owned commercial real property where regular depreciation is calculated using a 39-year life compared with a 40-year life under the rules applicable to tax-exempt use property.

As we previously have noted, the fractions rule is generally unworkable.[46] We indicated the statute should be amended to permit partnership allocations that have substantial economic effect and do not have a principal purpose of tax avoidance.

When the real estate exception was first enacted in 1980, it only applied to pension plans. One of the rationales for its enactment was that income earned by a pension plan enjoys only a temporary tax exemption. This tax deferral principal is not present for schools, which benefitted from an extension of this exception to them in 1984.

[46] See footnote 4.

b. Other Statutory Exceptions

Section 514 has more than its share of nooks and crannies that except or exempt various categories of debt-financed property and income from UBIT. For example, Section 514(c)(8) provides that payments with respect to securities loans do not constitute debt-financed income and the obligation to return collateral security is not treated as acquisition indebtedness. Under Section 514(c)(5), acquisition indebtedness does not include an obligation to pay certain annuities which are given in consideration for property. Under Section 514(c)(2), there is a ten-year UBIT holiday for certain debt-financed property acquired by gift or bequest. Section 514(b)(3) provides an exception to debt-financed income from certain real property used within ten years (fifteen years in the case of churches) for exempt purposes.

2. Exceptions in Rulings and Regulations

The IRS has created or blessed in rulings and regulations additional exceptions to the debt-financed income rules. For example, in Rev. Rul. 95-8,[47] the IRS ruled that a securities borrowing to make a short sale did not involve acquisition indebtedness. Further, in Rev. Rul. 76-95,[48] the IRS ruled that if a tax-exempt organization acquires an undivided interest in rental property subject to a mortgage and prepays its proportionate share of the mortgage indebtedness (receiving a release of liability from the mortgagee and co-owners), then the tax-exempt organization has no "acquisition indebtedness," even though the entire property remains encumbered by the mortgage.

[47] 1995-1 CB 107.

[48] 1976-1 C. B. 172.

Dividends and capital gains from REITs are not subject to UBIT even if the REIT holds debt financed real estate.[49] Swaps and other derivatives do not generate UBIT.[50] Thus, for example, rather than investing in a partnership with debt-financed real estate, a tax exempt not eligible for the Section 514(c)(9) debt-financed real estate exception could enter into a total return swap having the same economics.[51] In several private letter rulings, the IRS has ruled that charitable remainder trusts that acquire "units" from a university that have a return measured by the return on the university's endowment will not have debt-financed income, even if the endowment has investments that are debt financed.[52]

Further, the IRS has carved out an exception from acquisition indebtedness for certain short-term borrowings used to even out temporary cash shortages.[53] The IRS's rationale for these rulings is that infrequent, short-term borrowings to meet cash flow needs involve "transitory" indebtedness that is not incurred for the purpose of making investments; rather, the debt is incurred "solely for convenience in administering the tax-exempt entity's exempt function."

3. Offshore Blockers

A tax-exempt organization can avoid incurring acquisition indebtedness with respect to an investment in securities or commodities or non-U.S. real estate by investing through

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49 *See* Rev. Rul. 66-105, 1966-1 CB. 151. This assumes the investment itself is not debt-financed. The pension controlled REIT rules of Section 856(h)(3)(C) contain an exception to this rule for certain pension plan holders of REITs.

Similarly, non-debt-financed investments in RICs do not result in UBTI even if the RIC has debt-financed assets or investments in certain offshore corporations. *See* Section 852(b).

50 Reg. § 1.512(b)-1(a)(1) excludes from UBIT income derived from a notional principal contract.

51 Nugents, Possible Approaches for Avoiding UBTI on Real Estate Investments, Tax Notes, July 8, 2002, p. 271, text at footnote 109. This article also notes that participating debt and insurance company separate accounts can be used to invest in debt-financed property without UBTI.

52 *See*, e.g., PLR 200922061.

53 *See*, e.g., PLR 9644063, available at, 96 TNT 215-51; PLR 200320027, available at, 2003 TNT 96-21.

a foreign corporation incorporated in a tax-neutral jurisdiction, typically referred to as a "blocker corporation." The IRS has ruled privately that foreign blocker corporations are effective in avoiding Section 514.[54] A foreign blocker corporation is commonly used by tax-exempt organizations (often alongside foreign investors) to invest in a leveraged investment vehicle like a hedge fund or a private equity fund that is treated as a partnership for U.S. federal income tax purposes.[55]

4. Other Approaches to Structuring Around the Section 514 Rules

Given the incentives to avoid taxation under Section 514, other approaches to structuring around the debt-financed investment rules have been implemented. Critical to taxation under Section 514 is acquisition indebtedness. Thus, for example, structures in real estate and oil and gas partnerships may use preferred equity, rather than debt, to provide leverage. These structures are marketed as avoiding Section 514.

The timing of transactions is often considered in planning for Section 514. For example, if acquisition indebtedness is paid off more than twelve months before a debt-financed asset is sold, UBIT on the gain is avoided.

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[54] *See* PLR 199952086, available at, 2000 TNT 1-38 (respecting the separate existence of a non-U.S. corporation organized for the purpose of avoiding UBTI). In addition, the tax-exempt organization's gain from a sale of the blocker entity's stock will not be treated as UBTI. *See* TAM 69-18. A tax-exempt organization's sale of a partnership interest, on the other hand will be treated as UBTI if the partnership has debt-financed income. *See* TAM 9651001, available at, 96 TNT 248-27. For a discussion of use of blocker entities to avoid UBTI, see Andrew W. Needham, "A Guide to Tax Planning for Private Equity Funds and Portfolio Investments," Tax Notes, May 27, 2002, p. 1386.

[55] The use of foreign corporations for this purpose generally has not been marked as abusive. Dispensation for such structuring was effectively given by the House Report on H.R. 3996. *See* H.R. Rep. No. 110-431, 110th Cong. 1st Sess., at 146. *See also* the legislative history to Section 7701(o)(1) (the economic substance doctrine) which indicates that the doctrine does not alter the tax treatment of certain basic business transactions, including a U.S. person's choice of using a foreign or domestic corporation to make a foreign investment. Joint Committee on Taxation Technical Explanation of the Health Care and Education Reconciliation Act of 2010 at p. 152. Notwithstanding the refererence to a "foreign" investment, we do not believe that this is meant to suggest that the use of a foreign corporation to make a domestic investment is subject to question.

The debt-financed rules appear to apply on a tracing basis. Thus, tax-exempt organizations may have lines of credit or otherwise borrow money (generally secured by investment assets) and use the borrowings for charitable or other exempt purposes while continuing to acquire investment assets. Some organizations take the position that the new investment assets are not subject to acquisition indebtedness because no borrowed funds can be traced to such assets.

F. Computational Distortions

It has been noted that the rules for taxing unrelated debt-financed income overtax exempt organizations because a portion of the interest expense is allocated to the non-debt financed portion of the investment.[56] For example, if an exempt organization purchases (without using any leverage) a $100,000 bond that pays $7,000 of interest per year, the interest income is excluded from UBIT. If the organization purchases a similar $200,000 bond using $100,000 of its equity and $100,000 of money borrowed at a 6% interest rate, it will receive $14,000 in interest income per year and, after paying $6,000 in interest expense, have $8,000 of net interest income. However, because of the expense allocation rules, rather than being subject to UBIT on its $1,000 of incremental income, it would be subject to UBIT on $4,000 of interest income (the $14,000 gross income times the 50% debt to basis percentage reduced by the $6,000 of allowable deductions times the 50% debt to basis percentage).[57]

II. Use of Leverage by Tax Exempts – Good, Bad or Indifferent?

The critical policy question in looking at the debt-financed income rules is whether there is something inherently inappropriate in a tax-exempt's use of debt or other

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[56] McDowell at footnote 39, 2002 TNT 48-52, p. 19. *See* Reg. § 1.514(a)-1(b).

[57] The calculation of unrelated debt-financed income requires the application of the debt/basis percentage to the "total gross income derived during the taxable year from or on account of" the property. Reg. § 1.514(a)-1(a)(1)(ii). The same debt/basis percentage is also applied to the allowable deductions. Reg. § 1.514(a)-1(b)(1). *See* TAM 9717004.

leverage. If the use of debt or leverage should be discouraged, it may be appropriate for Congress to review the UBIT rules with an eye towards eliminating formalistic distinctions that result in different treatment for similar transactions.

A. General Policy Considerations

Below we describe certain policy considerations, stated or unstated, that may be relevant in this regard. In addition to the rationale given in the legislative history, various arguments have been made that tax exempts should be discouraged from borrowing or otherwise using leverage. As these arguments are largely based on concerns that are not integral to a tax system, we do not have the expertise or capacity to evaluate them, other than to note certain factors that might be taken into account in by those vested with the policymaker role in carefully considering their validity and where appropriate modeling possible outcomes.

1. Historical Stated Purpose

Congress's stated goal in 1950 and 1969 when it enacted the debt-financed income rules was to curtail abusive sale-leaseback transactions. Nothing in the legislative history to the Section 514 rules suggests that Congress thought a tax exempt's use of borrowing or leverage to make investments was in and of itself bad or to be discouraged.

The concerns about tax exempts trading on their exemption or effectively selling part of their exemption have effectively been dealt with under other sections of the Code.[58] Unlike sale-leaseback transactions that fall within the ambit of Section 512(b)(3)(B), deriving income from dividends, interest and similar passive investment income or trading in the underlying securities is not "trading on the tax exemption." For the reasons indicated in this

[58] *See*, *e.g.,* Section 512(b)(3) and the discussion at part I.C. above.

report, such activities should not turn into "trading on the tax exemption" when done on a leveraged basis.

2. Public Support Rather than Investment as Preferred Funding Source

The intended result of leverage is to increase the investor's return and the value of its net assets. Further there is a suggestion in the legislative history that a concern existed, at least with respect to charities, that permitting the exemption for portfolio investments to extend to leveraged portfolio investments might reduce responsiveness of charities to their public benefactors, by reducing their reliance on contributions.[59] It similarly has been argued[60] that exempt organizations (other than pension plans) should grow through public support or otherwise rely on contributions, donations and exempt activities, rather than the use of leverage, to fund their expenditures. Such a view would seem to us quixotic at best given the institutionalization of many tax exempts, the costs and effort incurred by a tax-exempt in seeking donations, the reduction in the tax benefit to donors as the result of reductions in tax rates since 1950 and actual or proposed limitations on the deductibility of itemized deductions.

3. Possible Interference with Mission of Tax-Exempt

Opposition has on occasion been voiced to the use of leverage by tax-exempt organizations on the basis that borrowing and other financing activities involve engaging in business-type activities other than purely passive investing and that such activities would tend to interfere with a tax-exempt's pursuit of its original goals and purposes.[61] By taxing unrelated business activities, the UBIT rules generally may act as a "nondiversion constraint" by focusing managers of tax-exempt organizations on their primary task of pursuing the organization's

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[59] 1980 Hearing at 297, statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury.

[60] *See* Hansmann at footnote 5.

[61] *See, e.g.*, Thomas E. Kimball, Note, *Tax Problems of Bootstrapping Sales to Exempt Foundations: A Comprehensive Approach.* 18 Stan. L. Rev. 1148, 1160 (1965).

exempt purposes.[62] While this may be true for the UBIT rules generally, we confess to some difficulty in seeing how the use of leverage, and not having to at times take extraordinary steps to avoid leverage, especially in the context of managed portfolio investments, would detract from a tax-exempt's focus or its functions or mission (or its responsiveness to benefactors).

4. Possible Undesirable Growth of the Tax Exempt Sector

Congress, the IRS and others have been concerned with the growth of the tax-exempt sector, in particular, whether large tax exempts are spending resources on charitable activities in a manner commensurate with their tax-exempt status and resources.[63] This concern has been expressly directed at universities with large endowments.[64] The legislative history to the 1950 Act also expressed a concern that under prior law, if left unchecked, sale-leaseback transactions could result in exempt organizations owning "the great bulk of the commercial and industrial real estate in the country . . . "[65]

5. Risks Associated with Leverage

It has been noted that debt or leverage involves risk that should not be encouraged.[66] Section 514 tends to discourage leverage, and the current-economic crisis has been principally attributed to over-leverage. If Section 514 were repealed or limited, it is likely that the leverage (and therefore the risk) inherent in the portfolios of 401(k) plans, IRAs, educational institutions and other charities would increase. Many pension plans and large

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[62] *See* Frances R. Hill, "Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint," 56 SMU L. Rev. 675 (2003).

[63] NYSBA Tax Section, "Report to Treasury Regarding the Use of the 'Commensurate in Scope' Test," available at http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1169Report.pdf (last visited July 6, 2010) ("NYSBA Commensurate Report").

[64] Charles Grassley (Sen., Iowa), "Wealthy Universities Must Make Themselves More Affordable," The Chronicle of Higher Education, May 30, 2008.

[65] See footnote 19.

[66] *See* McDowell at footnote 39, 2002 TNT 48-52, p. 21.

educational institutions are sophisticated and would wisely manage this potential for increased risk. But not all managers of 401(k) plans and not all individual beneficiaries who self-manage IRAs are sophisticated. In revisiting Section 514, Congress may want to consider the impact of leverage on 401(k)s, self-managed IRAs and smaller, less sophisticated exempt organizations. However, others counter that fiduciary considerations effectively deal with the issue of risk (excluding self-managed accounts).[67]

6. Competition for Debt Capital

It may be argued that, since debt capital is not unlimited, it is appropriate for Congress to limit competition from tax exempts for debt capital by imposing UBIT on tax exempts that employ borrowing in their investment strategies. It is conceivable that allowing such borrowing might have an upward effect on interest rates, and some income that otherwise would be taxable may become tax-exempt, and we believe that modeling would be appropriate. Apart from any revenue impact (discussed at point 7 below), this concern assumes that borrowing by tax-exempts should be disfavored as compared to borrowing by taxable entities, and is another way of stating the concern expressed as point 4 above.

7. Revenue Considerations

Consideration obviously must be given to the revenue impact of any change. In that regard, an analysis would take into account not only the additional revenue that may go untaxed and that would not already have been free of tax as the result of being held by, e.g., foreign investors, but also the displacement of an interest deduction for a tax-exempt's borrowing as compared with a taxable investor's borrowing and the displacement of possible tax-deductible losses. Also, the largest single source of tax-exempt funds is likely pension funds,

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[67] *See* McDowell at footnote 39, 2002 TNT 48-52, p. 21. *See* Reg. § 1.514(a)-1(b).

and earnings in that case generally would be in lieu of deductible contributions by the (generally) taxable employer.

Further, in many cases tax-exempts play a quasi-government role in our economy, as they serve to provide services and functions that otherwise would be expected, to one degree or another, from the government. Schools and institutions that cater to the indigent or needy are obvious examples, but the same holds true for, e.g., art institutions, institutions conducting medical or scientific research, and various other types to philanthropic organizations.

B. Considerations by Type of Tax-Exempt Entity

Different consideration might apply depending on the type of tax-exempt entity. For example, pension funds are vehicles for prudent investment and payment of pensions. Their primary mission is to invest prudently, for high performance long-term returns within an acceptable risk level. The better the long-term performance, the less need for tax-deductible contributions from corporate and other taxpayers. The investments typically are managed by professionally trained fund managers. Further, the earnings eventually are paid out as taxable compensation. For such an institution, issues about mission or size would seem irrelevant.

Endowments of universities and other educational institutions present a similarly strong case. These institutions serve a quasi-government function and their costs must be funded by sources that include deductible contributions if not by earnings. Further, the amounts earned typically are paid out on a nondeductible basis as income taxable to the recipients, whether teaching staff or other service providers.

Different considerations may apply to the endowments of public charities, including hospitals, art institutions, and so forth. On the one hand, many such charities are analogous to educational institutions in terms of the community importance of their functions

and their reliance on professionally trained money managers. On the other hand, as noted, there is an indication in the legislative history that reliance on donations, rather than active, leveraged investing, would promote the responsiveness of charities to their public benefactors.[68]

The case for private foundations is different from the case for public charities. Such organizations are subject to a minimum payout requirement under Section 4942 which requires them to distribute a minimum amount of their assets for charitable and other good Section 501(c)(3) purposes.[69]

C. Considerations by Type of Safe Harbor Income

Different considerations might apply to the certain of the safe harbor income categories. For example, it generally is assumed that most debt investments today are held in tax-exempt accounts or by tax-exempts or by foreign persons, and that the interest income is exempt from tax. With respect to such income, it is difficult to see a revenue (or other) concern with allowing leveraged investments by tax-exempts free of UBIT, even if the effect is to increase to some extent the net earnings of the tax-exempt.[70]

Certain types of income from a debt instrument of a domestic issuer (in particular, certain contingent interest and gain from the disposition of an instrument that participates in the appreciation of real property) is not generally exempt in the hands of foreign persons, and so a tax-exempt could not under today's law avoid taxation on the income from a leveraged

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[68] See footnote 57.

[69] In overview, the rules of Section 4942 require private foundations to pay out annually five percent of the value of their investment assets.

[70] In fact, relatively speaking, in a significant sense the use of leverage is more advantageous for a taxable investor, as the tax deduction for interest expense in effect subsidizes the leveraged portion of a taxable investor's acquisition. See part I.F. above.

investment in such instruments by using a foreign blocker. Whether allowing leverage for such debt would have a significant revenue cost should be considered.

Stock investments generally are subject to considerations similar to debt investments, including the inherent investment nature of the investments. In the case of stock of a U.S. issuer held by a foreign person, however, there is no general exemption from U.S. withholding tax on dividends paid, and treaties generally provide only limited relief. Further, gain from the disposition of a domestic United States real property holding company would be taxable to a foreign investor. Thus, a tax-exempt could not today avoid taxation on leveraged holdings of these investments by holding them through a foreign blocker.

Investments in IP are similar in certain respects, in that passive receipt of royalty income is a typical investment activity. Under domestic law, however, there is not an exemption for royalties paid in respect of IP used in the United States to a foreign person, though many U.S. income tax treaties do reduce the rate to zero. Thus, under today's law, a tax-exempt could not avoid U.S. tax on a leveraged investment in IP by holding it through a foreign (non-treaty country) blocker. Further, royalty income often is derived by exempt organizations from the licensing of their own names or other self-created IP. It is unclear what, if any, impact the application of Section 514 has to such assets, which typically are not debt financed.

Investments in royalty producing natural resources raise issues that implicate both the considerations applicable to investments in IP as well as the considerations applicable to real property. Interests in a mine, well or natural deposit is treated as a real property interest under FIRPTA and accordingly taxable to foreign persons. Further, royalties from natural resources generally would be subject to withholding tax. Thus, under current law, a tax exempt could not

avoid U.S. tax on royalties from leveraged natural resource investments by holding such assets through a foreign blocker. Also, as with real property, ownership of interests in natural resources can be closer to a true business than ownership of securities and other truly passive investment assets.

Real property investments have certain characteristics that differentiate them from the above categories to some extent. Most importantly, rents therefrom, and the gain on sale of the underlying property, generally are taxable to foreign investors. Further, ownership of real property can be closer to a business than ownership of securities, commodities or even IP. Also, the 1950 legislative history made specific reference, though only in the context of sale-leasebacks, to excess real estate ownership by the tax-exempt sector. On the other hand, alone among the categories of safe harbor income, under today's law, real property rents and gains may be derived by pension funds and schools on a leveraged basis without being subject to UBIT. Further, exempt organizations generally can invest efficiently in debt-financed real estate through REITs.

A consideration in respect of excepting only certain categories of safe harbor income from Section 514, while continuing to tax other types of debt-financed safe harbor income, is whether selective exceptions inappropriately distort investment behavior. Does the exception for debt-financed real estate income available to pension funds and schools, but not, e.g., stocks and securities, cause such entities to overweight their investment portfolios in leveraged real estate?

D. Investments via Partnerships

Many of the frictions encountered today are in the context of leveraged partnerships. While tax-exempts often are major investors in such partnerships, they generally are not controlling investors.

In general, we believe that leverage should be permitted or not permitted regardless of whether the investment is made directly or is made via a partnership. The testimony of a Treasury official in connection with Congress's consideration of section 514(c)(9)(E) is consistent:

> As a matter of policy, we think the character of income in the hands of a collective investment vehicle…should remain the same in the hands of the participants as it would be if they had made the investment directly.
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> . . . . What we are saying is that if one can make the argument, as a matter of policy, that pension funds which invest in real estate on a leverage basis should not be taxed, it should matter in what form they do it. [71]

Unlike direct leveraged investments, however, investments in partnerships raise additional issues. In particular, there is the issue whether permitting leverage will allow or exacerbate the ability of taxpayers to arbitrage the difference between taxable and tax-exempt partners through special allocations (often referred to as "waterfalls"). These issues led to the enactment of the so-called "fractions rule" in section 514(c)(9)(E), which provides byzantine restrictions designed to prevent any deferral in the timing or conversion of the character of income of taxable investors (as a practical matter, in particular, the general partner). We have already referred to our and others' comments on the fundamental flaws of the fractions rule from the standpoint of commercial reality and practice.

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[71] 1980 Hearings at 295, 316 (Statement of Daniel I. Halperin, Deputy Assistant Secretary of Treasury).

An issue that would have to be addressed is to what extent similar restrictions would be required in securities, commodities, or IP partnerships if leverage were permitted (e.g., to prevent the interest deductions from being allocated to the general partner followed by a chargeback of capital gains income as the back end of the deal). For example, in this context, would the current Section 704(b) substantial economic effect rules be considered to provide enough, though imperfect, protection against abuse? Further, in the area of partnerships investing in natural resources, rules similar to the rules for real estate might be appropriate if leverage were permitted for such assets.

III. Reexamination of Section 514 Is in Order

This report discusses the origins and the evolution of the debt-financed income rules of Section 514. The legislative history clearly demonstrates that UBIT is intended to prevent tax-exempt organizations from competing unfairly with taxable businesses. Congress decided to exempt passive income (including interest, dividends, rents, royalties and capital gains) from UBIT because such passive income traditionally has been earned by tax exempts and is not likely to give tax exempts a competitive advantage. The legislative history to the 1950 Act and the 1969 Act shows the debt-financed income rules of Section 514 were aimed at eliminating abusive sale-leaseback transactions such as the one litigated in *Clay Brown*. Although the application of Section 514 as amended in 1969 to all investments is clear, it is not entirely clear from the legislative history that Congress felt taxing routine investments acquired with borrowed money or leverage achieves any particular policy goal.

We believe that the types of abusive transactions that prompted the enactment of Section 514 generally are effectively impeded by Code provisions outside of Section 514 (principally by Section 512(b)(3)(B)) or otherwise could not be replicated (e.g., because of the

repeal of the *General Utilities* doctrine, enactment of imputed interest rules, etc.). However, we acknowledge that abuses – both real and perceived – did occur in connection with leveraged acquisitions of real estate and operating businesses prior to the enactment of Section 514. The possibility of abuses reappearing, particularly in partnerships with both taxable and tax-exempt partners, needs to be guarded against.

In large part, we have come to the conclusion that alternative compelling policy rationales for Section 514 are not apparent from the legislative history. If Section 514 is intended to control the size of tax-exempt organizations or to protect tax-exempt organizations from the evils of leverage and over-leverage, it is a very blunt tool and not efficient.[72] Section 514 has become a patchwork of exceptions and exemptions, many or most of which do not appear to have a coherent policy justification. Finally, Section 514 often either can be structured around or avoided by engaging in transactions that are economically equivalent to transactions that are subject to tax. We recommend that Congress revisit and thoroughly reexamine Section 514.

1. Possible Repeal of Section 514

Section 514 was intended, in large part, to prevent tax-exempt organizations from acquiring real estate or operating businesses and, in effect, converting a taxable owner's ordinary income into capital gains. Consistent with the position and testimony of the Tax Section before the 91st Congress,[73] we do not believe that, taking into account other applicable provisions, there is any meaningful potential for that abuse in the case of investment property, assuming certain

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[72] As noted above, we emphasize that we do not hold ourselves out as experts on the nontax policy considerations and the economic issues in this regard and referred to in part II of this report.

[73] See footnote 31.

provisions are retained or enacted to prevent abusive sale-leaseback transactions and potentially abusive partnership transactions.

The legislative history to Section 514 indicates that Congress was not so much concerned with the use by tax-exempt organizations of leverage *per se* but, rather, with the use of leverage in the context of transactions where a tax-exempt organization was, in effect, trading on its tax exemption - - that is, where the tax-exempt organization inserts itself into an operating business structure, in effect contributing its tax-exempt status to the transaction. Where a tax-exempt organization makes an investment using its own equity along with some leverage, it does not "trade on its tax exemption" any more than when it makes a non-leveraged investment.

The legislative history to the 1950 Act also expressed the concern that, unchecked, sale-leaseback transactions could result in tax-exempt organizations overpaying for property or charging below market rents, in effect selling part of their exemption. We generally do not see any reason for a tax-exempt organization using leverage to behave differently in this regard than a tax-exempt organization not using leverage, or than a taxable investor using leverage, either in the amount it is willing to pay for an asset or the return it is willing to receive on such investment. In the absence of Section 514, certain seller-financed sale-leasebacks of real estate and certain leveraged partnerships among tax-exempt and taxable partners potentially could give rise to these concerns and we would encourage any reform in this area to consider carefully what safeguards might be needed to avoid abuses involving such transactions. Outside of seller-financed sales of real estate, we see no incentive for an exempt organization, using leverage or not, to overpay for an asset and no incentive for a lender to allow it to overpay.

Finally, the legislative history to the 1950 Act expressed a concern that if unchecked, sale-leaseback transactions could result in exempt organizations owning the great

bulk of commercial and industrial real estate in the country, resulting in a reduction of the rental income included in the tax base. The concern in the case of real estate may have been more pronounced because of the relatively high leverage traditionally permitted for real property. The concern was expressed when the incentives for investment by taxable investors in real estate were less generous, and prior to the introduction of the REIT regime and the proliferation of real estate partnerships, which together effectively removes real estate rents and gain from the corporate tax base.

More generally, outside of the real estate context, the use of leverage in investing certainly is intended to increase the investor's return on its equity. Congress already has expressed concerns on the growth of the tax-exempt sector, particularly university endowments.[74] A repeal or scaling back of Section 514 might encourage exempt organizations to leverage their portfolios, within limits, in hopes of increasing overall returns and growing the portfolio. Congress could conclude that it does not desire to encourage such growth by reducing the scope of Section 514. However, even if Congress has such concerns, it could encourage greater accountability and increased expenditures on charitable and educational activities commensurate with the size and scope of the exempt organization's assets.[75]

In our experience, Section 514 does not stop tax-exempt organizations from making leveraged investments, and we suspect that Section 514 does not raise significant revenues, with the possible exceptions of debt-financed real estate investments by charities and other tax-exempt organizations that are not eligible for the Section 514(c)(9) exemption available to pension funds and schools and investments in domestic hedge funds or other securities funds

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[74] Press release from Sens. Chuck Grassley and Max Baucus; Senate Committee on Finance (Jan. 24, 2008), *available at* finance.senate.gov/press/Gpress/2008/prg012408b.pdf.

[75] *See* NYSBA Commensurate Report at footnote 63.

by tax-exempt organizations that, because of lack of sophistication or otherwise, do not hold such investment through offshore blocker corporations (although additional revenues might be involved to the extent, e.g. that U.S. dividend paying stocks migrated from taxable investors to tax-exempts as the result of the ability to hold them with leverage).

This report has largely focused on investments by tax-exempt organizations in real estate and securities and commodities. In addition to such assets, the general UBIT exemptions for passive investment income apply to IP royalties, natural resources royalties and capital gains from the underlying property. We see no reason why debt-financed investments in assets generating royalties, whether from intellectual property or from natural resources, should be treated differently from investments in real estate or securities and commodities. Similarly, we see no reason to distinguish the taxability of capital gains from other types of investment income in the application of Section 514.

We encourage Congress to consider seriously whether outright repeal of Section 514 might be appropriate as a policy matter,[76] considering that in modern portfolio management, use of some leverage in some sectors is routine and expected. We acknowledge that partnerships, particularly real estate partnerships, with exempt and non-exempt partners potentially could provide an avenue for abuse if 514 were repealed. Accordingly, in connection with any review of the overall desirability of Section 514, it may be appropriate for Congress to consider the need for a general anti-abuse rule to cover not only seller-financed sale-leasebacks of real estate, but also partnerships and any other economic sharing arrangements that involve both taxable and tax-exempt organizations where the tax exempt might get a better deal for

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[76] *See* Weigel, footnote 4 at p. 658 (arguing for a repeal of Section 514); Boris I. Bittker and George K. Rahdert, "The Exemption of Nonprofit Organizations from Federal Income Taxation," 85 Yale L.J 299 (arguing for a repeal of the UBIT rules with respect to certain organizations).

allowing the use of its tax exemption.[77] It may be appropriate for any anti-abuse rule to be aimed at transactions where tax avoidance is "a" principal purpose of the structure, as opposed to where tax avoidance is “the” principal purpose of the structure of the transaction. Prior to undertaking the repeal of Section 514, the revenue implications need to be fully understood.

If outright repeal of Section 514 cannot be justified, or cannot be accomplished in the current legislative environment on revenue grounds, we encourage Congress to revisit various discrete aspects of Section 514, as discussed below.

2. Possible Expansion and Rationalization of Real Estate Exception

The Code currently excludes from "acquisition indebtedness" indebtedness incurred by certain tax-exempt organizations (essentially pension plans and schools) in connection with the acquisition or improvement of real property. We believe reconsideration should be given to whether in today’s environment any meaningful policy reason justifies exempting some, but not all, tax-exempt organizations from UBIT on debt-financed real estate.

Further, we and others have noted that the current rules applicable to debt-financed real estate held by partnerships, particularly the fractions rule, is seriously flawed and in need of a legislative fix. We encourage Congress to address this issue.

3. Possible Exceptions for Securities and Commodities

We believe that the rationale underlying the exclusion for debt-financed real property applies equally to other investment assets, particularly securities or commodities.[78]

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[77] *See* discussion at parts I.E.1.a. and II.D. above.

[78] The exclusion from Section 514 provided for in proposed legislation such as H.R. 3497 generally would apply to debt-financed acquisitions by a partnership of shares of stock in a corporation; partnership or beneficial ownership interests in widely held or publicly traded partnerships or trusts; evidences of indebtedness such as notes or bonds; interest rate, currency and equity notional principal contracts; actively traded commodities; notional principal contracts with respect to such commodities; and evidences of an interest, or derivative instruments, in any of the foregoing, such as options, forward contracts, futures contracts or short positions.

Among other things, the exemption to the debt-financed property rules of Section 514 for certain debt-financed real estate investments made by qualified organizations within the meaning of Section 514(c)(9)(C) was predicated on the fact that debt-financing is common in real estate investments and Congress believed that it was inappropriate to apply the restrictions on debt-financed property to the extent that they discouraged prudent debt-financed real estate investments. We believe that the same considerations that prompted the exception for debt-financed real property are present in the case of other types of investment property, particularly securities and commodities. As with real property, debt financing is common, if not ubiquitous, with respect to investments by, e.g., hedge funds and private equity vehicles. Moreover, such investments form an important part of many tax-exempt organizations' investment strategies and, in the absence of a potential for abuse, which we do not believe exists, we do not believe that it is appropriate to discourage such investments.

In light of the structuring possibilities available to tax-exempt organizations involving offshore blocker corporations, subject to the exceptions described above (particularly for contingent interest on debt of U.S. issuers and dividends on shares of U.S. issuers), income from debt-financed securities and commodities (and non-U.S. real estate and non-US IP) generally is subject to UBIT only in the case of tax-exempt organizations that are not properly advised. Thus, in this context, Section 514 introduces, without the potential of raising meaningful revenue, gratuitous structuring complexity whose beneficiaries are neither the government nor the affected tax-exempt organizations.

Exempting debt-financed income from UBIT with regard to securities and commodities would be a reasonable step towards simplifying the Code and reducing tax-induced friction. Such an exemption also would eliminate the need for tax-exempt organizations to

establish offshore blocker corporations and, thus, is consistent with and supports current proposals by Congress to curtail the use of offshore entities. In connection with such an exemption, as noted above, consideration would have to be given to whether an anti-abuse rule serving the function of the “fractions” rule would be required for securities and commodities partnerships. As noted below, such legislation also should consider the viability of blocker corporations in contexts not protected by the legislation.

H.R. 3497, if enacted, would amend Section 514 to exclude from the "acquisition indebtedness" any indebtedness incurred or continued by a partnership, in which the organization is, directly or indirectly through another partnership, a limited partner, in purchasing or carrying any "qualified security or commodity." For this purpose, a qualified security or commodity generally would be any security (including any Section 1256 contract) or commodity, as defined in Sections 475(c)(2) and (e)(2) respectively, or any option or derivative contract with respect thereto.

As indicated above, we do not believe it would be appropriate to exempt investments by tax-exempt organizations in leveraged partnerships that invest in securities and commodities, but not exempt direct debt-financed investments by tax-exempt entities in securities or commodities. Although the principal relevance of a securities and commodities exception will be to tax-exempt organizations that invest in hedge funds and private equity vehicles, the exception would also be relevant to a number of tax-exempt organizations which, because of their size and sophistication, make such investments directly. This same issue was considered with respect to the exemption for debt-financed real property. While the exception in that case was aimed primarily at indirect investments in real property, the Committee stated that "in order to alleviate a competitive problem, it is appropriate to allow qualified plans to make

debt-financed investments directly." Just as we believe that the general policy rationale of the exception for debt-financed real estate is applicable to the property covered by H.R. 3497, so too we believe that the competitiveness concern is equally applicable and that direct investments should be included in the exception.

4. Possible Retention and Rationalization of Section 514

Following a review, Congress may determine that Section 514 is considered, broadly speaking, to appropriately implement relevant policies, at least for certain types of investments and certain types of tax-exempts. Given that tax exemption can be viewed as equivalent to a tax expenditure, Congress may conclude that that expenditure is appropriately limited to nonleveraged investments. To the extent that leveraged investments should result in UBTI, we recommend that Congress review the policies behind the relevant exceptions and exemptions to Section 514 with an eye towards eliminating formalistic and other distinctions.

Among other items, such a review could consider the scope of debt financed property, including whether certain synthetic debt arrangements or alternative investment strategies should continue to be excepted. Such a review may conclude that Section 514 should be amended to tax certain transactions involving certain of such alternatives forms of investment where a direct investment in debt-financed property would be taxable.

For example, as noted above, Section 514 can be avoided through the use of swaps (notional principal contracts) and other derivatives. For Section 514 purposes, Congress could treat a tax-exempt that enters into an equity swap or similar agreement as having borrowed the notional amount of the swap (or other derivative) to purchase the underlying securities or other property. Or Congress could limit this treatment to certain "abusive" equity swaps and similar agreements (*cf.*, Section 871(l)).

As mentioned above, under current law, a tax-exempt organization may easily avoid Section 514 for many investments simply by investing in a foreign corporate "blocker" or private REIT that borrows to make investments. Congress may want to consider preventing the use of foreign blockers or private REITs to avoid Section 514 by providing that a tax-exempt organization's share of the entity's indebtedness is attributed to the tax-exempt organization shareholder. In addition, Congress may want to consider whether any changes in the definition of acquisition indebtedness are needed to address situations where an exempt organization borrows to finance exempt activities while continuing to acquire investment assets that in form are not financed with acquisition indebtedness.[79]

As noted above, any review also should reconsider the fractions rule.

This report gives an overall picture of Section 514 and its application to various investment transactions. We would be pleased to write more comprehensively about any of the items touched on in this report. In particular, we would welcome an opportunity to elaborate on how anti-abuse rules could be drafted and implemented without the exceeding complexity of the fractions rule.

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79 The IRS potentially could address this issue in regulations or rulings.