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UBIT PROBLEMS FOR TAX-EXEMPT CHARITABLE TRUSTS

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I. *Introduction*

The unrelated business income tax ("UBIT") was added to the Internal Revenue Code in 1950 and expanded in 1969 to apply to virtually all exempt organizations. Its purpose is to eliminate a source of unfair competition by taxing certain income-producing activities of exempt organizations in the same manner as the for-profit businesses with which they compete. The effect of the UBIT rules is to impose a tax, at normal corporate or trust rates depending on the form of the organization, on net profits derived from the conduct of certain income-producing activities that do not further the organization's exempt purposes.[1]

Exempt organizations may be subject to UBIT as a result of conducting active business operations that are unrelated to their exempt purposes, or as a result of holding certain types of investments that fail to qualify for the specific UBIT exemptions that are accorded many types of passive investment income. Since most charitable trusts exempt under Section 501(c)(3) and charitable remainder trusts exempt under Section 664 are not formed to engage in active business operations, this outline will focus principally on the UBIT consequences of various types of investments they may hold.

Charitable trusts need to understand the UBIT rules for three critical reasons. *First*, since the income and appreciation on many types of assets and investments are wholly tax-exempt, charitable trusts and their donors need to take any UBIT implications into account in evaluating the effective economic rate of return of a particular investment or contribution. *Second*, in the case of a charitable remainder trust ("CRT"), *any* unrelated business taxable income during the year will cause the CRT to lose tax exemption on *all* income for that year. *Third*, charitable trusts that are classified as private foundations are subject to the excess business holding rules under Section 4943, which impose excise tax penalties on the ownership of more than specified percentages in business enterprises that are not functionally related to the foundation's exempt purposes.

This outline will review the consequences of UBIT to charitable trusts. It will also provide an overview of the general UBIT rules, with particular focus on the exceptions for certain types of investment rules relating to investments and on the unrelated debt-financed income, including tax planning strategies to minimize UBIT in conjunction with some of the most common investment activities of charitable trusts.

II. *Impact of UBIT on Tax Exemption of Charitable Trusts and CRTs*

This outline will focus on three types of charitable trusts: those exempt under Section 501(c)(3) and classified as public charities; those exempt under Section 501(c)(3) and classified as private foundations; and charitable

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1/ IRC Section 511 imposes the tax on unrelated business income of exempt organizations. IRC Section 512 defines the scope of unrelated business taxable income. IRC Section 513 defines what constitutes an unrelated trade or business. IRC Section 514 sets out special rules that subject certain debt-financed income to UBIT.

remainder trusts that are exempt under Section 664. The consequences of having unrelated business income are different for each of these categories.

A. *UBIT Implications for Charitable Trusts Classified as Public Charities*

Most public charities are established in the form of nonprofit corporations. However, some are established as charitable trusts, including, for example, some community foundations. Public charities, including those organized as charitable trusts, are not subject to any specific limitation on the amount of unrelated business income they may have without jeopardizing their exempt purposes, so long as that is not their primary purpose, and they engage in a program of charitable activities that is commensurate in scope with their resources. *See*, *e.g.*, Treas. Reg. § 1.501(c)(3)-1(e)(1). In determining whether the operation of an unrelated trade or business is a charitable organization's primary purpose, the regulations provide that all facts and circumstances must be considered, including the size and extent of the unrelated trade or business in relation to the organization's exempt purpose activities. *Id.*

The absence of a bright-line standard leads to the frequent question: exactly how much UBIT is too much? It is hard for many charitable organizations to accept the fact that there is simply no absolute standard for this rather fundamental point. As a practical matter, however, it is often advisable for charitable organizations to consider establishing for-profit subsidiaries when their income from unrelated business activities begin to approach 25% - 30% of their overall revenues. When UBIT activities reach these levels, it may be desirable to put them in a for-profit corporate subsidiary for liability protection reasons -- to avoid putting exempt purpose activities and assets at risk for any liabilities that may be attributable to the unrelated business activities. This is often a sensible approach from a business perspective, and it has the corollary benefit of protecting the organization from an IRS challenge to exemption.

B. *UBIT Implications for Private Foundations*

Section 4943(a)(1) imposes an excise tax of 5% on the "excess business holdings" of private foundations. Foundations that fail to divest themselves of such excess business holdings during a specified correction period are subject to an additional 200% excise tax under Section 4943(d)(2).

The excess business holding rules generally limit a private foundation's ownership of stock or other interest in a business enterprise to not more than 20% of the combined ownership of the foundation and all disqualified persons; the limit may be increased to 35% if third parties have effective control over the business enterprise. The definition of an excess business holding expressly includes a business owned and operated directly by a foundation, and therefore private foundations that engage in business activities which are subject to UBIT must consider whether such activities may violate the excess business holding rules.

C. *UBIT Implications for CRTs*

Section 664(c) provides that a charitable remainder unitrust shall, for any taxable year, be exempt from tax unless such trust has unrelated business taxable income. Treas. Reg. § 1.664-1(c) explains quite clearly the limitation of this exemption:

> if the charitable remainder trust has any unrelated business taxable income . . . for any taxable year, the trust is subject to all the taxes imposed by . . . the Code for such taxable year.

Under these rules, UBIT is fatal to the exempt status of a CRT. Even $1 of unrelated business taxable income will cause a CRT to lose its exemption for the year, and to be subject to tax on all its income under the rules

generally applicable to a complex trust.

In *Leila G. Newhall Unitrust v. Commissioner*, 105 F.3rd 482 (1997); 79 AFTR 2d (RIA) 547 (9th Cir. 1997), the Ninth Circuit confirmed this result. The case involved a charitable remainder trust which received income from publicly traded partnerships. During the years at issue, such income amounted to 20% and 14%, respectively, of the CRT's gross income. The court first held that such income was unrelated business taxable income, then sustained the IRS position, based on Section 664(c) and the regulations thereunder, that the receipt of this income caused the CRT to lose its tax exemption for the years at issue. Noting that the statute and regulation had a draconian impact in the case (during the years at issue, the CRT's income tax liability was approximately three times its unrelated business taxable income), the court nevertheless concluded that the statute was not "so bizarre that Congress could not have intended it."[2]

III. *Overview of General UBIT Rules*

A. *Definition of Unrelated Trade or Business*

Section 511 imposes a tax on the gross income (less directly connected expenses) derived by an exempt organization from an "unrelated trade or business." There are three criteria for an activity to constitute an "unrelated trade or business:" it must be (1) a trade or business; (2) regularly carried on; and (3) not substantially related to the organization's exempt purpose.[3]

1. *Trade or Business*

A trade or business is generally defined as any activity carried on for the production of income from the sale of goods or performance of services.[4] Courts have held that the existence of a profit motive is central to the determination that a particular activity is a trade or business.[5]

2. *Regularly Carried On*

Trade or business activities are ordinarily deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations. Income-producing activities conducted by a nonprofit organization on an infrequent or intermittent basis do not meet the "regularly carried on" requirement.

3. *Substantially Related*

Whether an activity is "substantially related" is a factual question, based on the relationship between the activity and the accomplishment of the organization's exempt purpose. Income derived from an activity which contributes importantly to or furthers the organization's exempt purposes (other than through the generation of revenues) will not be unrelated business income. For example, the IRS has ruled that an art

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2/ *See Demarest v. Manspeaker*, 498 U.S. 184 (1991).

3/ Section 513(a); Treas. Reg § 1.513-1(a).

4/ Treas. Reg § 1.513-1(b).

5/ *United States v. American Bar Endowment*, 477 U.S. 105, at 110 n. 1 (1986); 58 AFTR 2d (RIA) 5190 (1986).

museum gift shop's sale of greeting cards that display printed reproductions of selected works from its collection is substantially related to the exempt purposes of the museum. However, it also held that the sale of scientific books at the gift shop is not related to the museum's exempt purposes, which do not include educating the public about scientific matters. Accordingly, the IRS held that income from the sale of scientific books generates unrelated business income to the art museum, even though the same activity would be substantially related in the context of a scientific history museum.[6]

B. *Specific Exclusions*

Section 513 provides specific exclusions from UBIT for income derived from certain types of activities. Some more common exclusions include a trade or business where substantially all of the work is carried on by volunteers;[7] a trade or business carried on primarily for the convenience of members, students, patients, officers or employees;[8] a trade or business where substantially all of the merchandise is donated;[9] distribution of low-cost articles as incidental to charitable solicitation program;[10] rentals or exchanges of mailing lists between Section 501(c)(3) organizations and veteran organizations;[11] and qualified sponsorship payments.[12]

C. *Specific Modifications*

In addition to the exclusions described above, Section 512(b) contains "modifications" which exempt certain items of income and related deductions from UBIT treatment (as discussed below). Since these UBIT modifications exempt many forms of passive investment income, they are important to charitable trusts in structuring investments, particularly including CRTs trying to avoid the taint of UBIT. Caveat, however, that (as discussed below) certain income excluded from UBIT under the modifications contained in Section 512(b) may nevertheless be subject to tax if the income is debt-financed under Section 514, or if it is derived from a controlled subsidiary.

1. *Dividend, Interest and Annuity Income*

Section 512(b)(1) excludes from UBIT all dividends, interest, income from notional principal contracts and annuities, plus all amounts paid as consideration for entering into loan agreements. The regulations also

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6/ Rev. Rul. 73-105, 1973-1 C.B. 264.

7/ Section 513(a)(1).

8/ Section 513(a)(2).

9/ Section 513(a)(3).

10/ Section 513(h)(1)(A).

11/ Section 513(h)(1)(B)(i) and (ii). Although this statutory UBIT exception is limited to mailing list rentals and exchanges between certain categories of exempt organizations, courts have repeatedly held that income from the rental or exchange of mailing lists is also exempt as a royalty under Section 512(b)(2). *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), on remand, T.C. Memo 1999-86 (1999); *Oregon State University Alumni Assn. v. Commissioner*, 193 F.3rd 1098 (9th Cir. 1999); 84 A.F.T.R. 2d (RIA) 6515 (9th Cir. 1999).

12/ Section 513(i).

specify that "other substantially similar income from ordinary and routine investments" is also excluded.[13] This does not apply, however, to income earned by organizations that may be characterized as brokers or dealers from ordinary and routine investments; such income does not qualify for the exclusion.[14]

a. *Securities Loans*

Section 512(b)(1) excludes from UBIT all payments with respect to securities loans, which includes income derived from a securities lending transaction in which an exempt organization loans securities from its portfolio to a broker in exchange for collateral. Payments from securities lending transactions may include interest earned on the collateral, as well as dividends or interest paid on the loaned securities while in the possession of the broker. To qualify for the exclusion, the transaction must be made pursuant to an agreement with the broker which includes the following terms:

(1) provision for the return to the organization of securities identical to those transferred upon termination of the loan;

(2) provision for payments to the organization of amounts equal to the interest, dividends and other distributions that the owner is entitled to receive during the period of the loan;

(3) provision for procedures to implement the obligation of the broker to provide collateral with a fair market value of not less than the loaned securities; and

(4) provision for termination of the loan by the organization upon not more than five business days' notice.[15]

b. *Subchapter S Corporations*

Note, however, that the exclusion for dividends does not include those received from S corporations. Although The Small Business Job Protection Act of 1996 liberalized Section 1361 to permit Section 501(c)(3) organizations to be shareholders in S corporations, the price for such liberalization was to subject them to UBIT on all income or loss related to S corporation stock, including dividends and gains or losses from the disposition of such stock.[16]

2. *Royalty Income*

Section 512(b)(2) excludes from UBIT payments for intangible property rights, including not only royalties from mineral properties but also payments for the use of the name and logo of an exempt organization.[17] The

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13/ Treas. Reg. § 1.512(b)-1(a)(1).

14/ Treas. Reg. § 1.512(b)-1(a)(2).

15/ Section 512(a)(5)(B)(ii).

16/ Section 1361(c)(6).

17/ Section 512(b)(2); Treas. Reg. § 1.512(b)-1(c).

regulations provide specifically, however, that royalties do not include income from working interests in mineral properties where the exempt organization pays a share of the development costs.[18]

Many of the issues concerning the royalty exemption have arisen in the context of mailing list rentals and affinity credit card arrangements. Although the IRS asserted for many years that mailing list rentals and affinity card arrangements (where the exempt organization licenses its name, logo and mailing list to a financial institution) do not fall within Section 512(b)(2), courts have repeatedly rejected that position,[19] and the IRS has announced that it will no longer assert that position on audit or in litigation.

Royalties do not, however, include payments for personal services. *See*, *e.g.*, Rev. Rul. 81-178, 1981-2 C.B. 135, in which the IRS held that payments received by a players' association from the licensing of players' names and likenesses qualified as a royalty, but that payments under an arrangement which included a requirement of personal appearances and endorsements were for services and did not constitute a royalty. At issue in many of the cases involving affinity card arrangements was whether the exempt organizations were providing more than a *de minimis* level of marketing and promotional services to the financial institutions. Although the courts have uniformly held that the small level of services involved in those arrangements was not sufficient to disqualify the arrangements from the royalty exemption, at least one court raised the possibility that it might be appropriate in some cases to bifurcate the arrangements and treat a portion of the consideration as compensation for services.[20]

3. *Rental Income*

Section 512(b)(3) provides that rents from real property, as well as rents from incidental personal property leased with real property (not exceeding 10% of total rent) are excludable from UBIT. This UBIT modification is subject to three important exceptions.

a. *Personal Property Rental Income*

Rental income from the leasing of personal property is exempt from UBIT only if the personal property is an incidental part of a lease of real property *(i.e*., the personal property rental does not exceed 10% of the total rental under the lease). If the personal property component is more than 10% but not more than 50% of the total rental, then only the personal property component is subject to UBIT. However, if more than 50% of the total rent accrued under the lease is attributable to personal property, none of the rental income from either the personal property component or the real property component is excludable from UBIT. Exempt organizations cannot circumvent this rule by executing separate leases for real and personal property; if the real and personal property have an integrated use, then the multiple leases will be treated as a single lease.

b. *Payments for Services*

Payments for services, including the use or occupancy of rooms and other space, are not treated as rents from real property. The regulations provide that this includes payments for the use or occupancy of rooms or other quarters in hotels, boarding houses or apartment houses furnishing hotel services, or in tourist camps or

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18/ Treas. Reg. § 1.512(b)-1(b).

19/ See n. 11, *supra*.

20/ *Oregon State University Alumni Assn. v. Commissioner*, 193 F.3rd 1098 (9th Cir. 1999); 84 AFTR 2d (RIA) 6515 (9th Cir. 1999)

tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages.[21] The regulations provide further that the key issue is whether the services are primarily for the convenience of the occupant and are services other than those usually or customarily rendered in connection with that type of property. For example, the regulations provide that the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, and the collection of trash are customary-type services and are not considered services rendered to the occupant. *Id.*

The question of whether a particular rental arrangement involves the provision of services arises frequently in the context of charitable organizations that own commercial real estate. The treatment of income from parking lots that are part of such commercial real estate is a particular subject of concern. Since the regulations cited above provide that payments for the use or occupancy of space in parking lots are not treated as rents from real property, the IRS has taken a fairly restrictive position on the question of whether parking lot income is subject to UBIT. In general, the IRS has been willing to rule that income from the rental of a parking lot is not subject to UBIT only where no services are provided by the exempt organization.[22] For example, PLR 8904002 (Oct. 24, 1988) involved a charitable organization that owned a 17-story office building and an adjacent parking lot for tenants and employees. The organization used the building for its own office space; it also provided space to its outside fundraiser and to third parties. The only services provided by the organization in connection with the parking lot were attendants stationed at the entrance and exit. The IRS nevertheless held that the operation of the parking lot was an unrelated trade or business, and that the parking lot income was subject to UBIT. In many cases, charitable organizations choose to lease the parking lot to a commercial parking lot operator in order to ensure that the income derived from the parking lot is not subject to UBIT.

c. *Rental Income Based on Income and Profits*

The UBIT exception for rents from real property does not apply if the rents are based in whole or in part on the income or profits derived by any person from the leased property (other than an amount based on a fixed percentage of receipts or sales).[23] This is an important distinction, since rental formulas based on net profits have become customary for commercial buildings. Such leases would, however, have adverse tax consequences for tax-exempt landlords, and these generally can be avoided with comparable economic return on a tax-free basis by structuring the rental arrangement to come within the applicable UBIT exception.

For purposes of determining when rents are based on income or profits, the regulations refer to the REIT regulations contained in Treas. Reg. § 1.856-4.[24] These regulations permit a variety of rental agreements based on fixed percentages of receipts or sales. Percentages may vary with regard to various factors in the lease agreement, but they must be fixed at the time the lease is executed. For example, rental amounts may be determined by a percentage of receipts or sales "in excess of determinable dollar amounts," so long as the percentages are fixed at the time the lease is entered into.[25] The regulations also provide that a lease agreement

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21/ Treas. Reg. § 1.512(b)-1(c)(5).

22/ *See*, *e.g.*, PLR 8720005 (Feb. 20, 1987); PLR 8445005 (July 11, 1984).

23/ Section 512(b)(3)(B)(ii).

24/ Treas. Reg. § 1.512(b)-1(c)(iii)(b). This regulation expressly incorporates Treas. Reg. § 1.856-4(b)(3), (b), other than (b)(6)(ii).

25/ Treas. Reg. § 1.856-4(b)(3).

may specify differing percentages of receipts or sales from different departments or from separate floors of a retail store, but only if the percentages are fixed at the time the lease is entered into.[26]

PLR 8932085 (May 19, 1989), provides an example of a ground lease arrangement by a Section 501(c)(3) organization involving a complex rental formula that was held by the IRS to be "rents from real property" and therefore exempt from UBIT. The IRS ruled that rents based, in part, on the following factors would not be considered based on the income or profits derived from the property: (1) the square footage of the building; (2) the date the tenant first occupies the building; (3) inflation in real estate values; (4) the appraised value of the leasehold; (5) the appraised value of the property leased; (6) a percentage of the net proceeds from a financing of the leasehold estate; (7) a percentage of the net proceeds from a sale of the leasehold estate; and (8) taxes, insurance premiums, damages resulting from the tenant's failure to maintain insurance, and amounts paid on behalf of the tenant in connection with the discharge of liens.

(1) *Crop-Share Leases*

The issue of whether rents are based on income or profits versus a fixed percentage of receipts has been litigated in a number of cases involving crop-share leases between trusts which own farms and their tenants. Crop-share leases are agreements between a landowner and a farmer that specify how the farmer is to conduct a farming operation on the landowner's property. Typically, the landowner and the farmer split the associated farming costs and the farmer pays his rent in the form of a percentage of the farm's annual production. Despite IRS efforts to characterize those arrangements as partnerships and such rents as includable in unrelated business income, courts have consistently held that crop-share leases are not partnerships or joint ventures, and that the rents are fully excludable from UBIT because they are "based on a fixed percentage" of gross returns, rather than dependent on income or profits.[27]

For example, in *Moore Charitable Trust v. United States*, the Seventh Circuit held the payment of a portion of farming expenses by a charitable trust under a sharecrop agreement did not cause the in-kind rent received by the trust to be treated as rent determined by income or profits, and therefore such rent qualified for the UBIT exemption under Section 512(b)(3). In that case, the charitable trust leased land to a tenant, with each party paying one-half of the cost of such expenses as seeds, herbicides, insecticides, fertilizer, soil tests and grain drying. The tenant performed the farming activities and delivered one-half of the crops to the trust. The court rejected the IRS' argument that the arrangement was in the nature of a partnership. The IRS has acquiesced in the *Moore* decision and, as a result, will not challenge the UBIT exemption of in-kind rental payments under crop-share arrangements, as long as the rental is not tied directly to the net income from the property.[28]

(2) *Impact of Subleases*

The IRS has successfully taken the position that the restriction against receiving rental income based on income or profits applies not only to rents received directly by an exempt organization, but also to rents received indirectly from a subtenant, where the primary lease provides that the exempt organization is to

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26/ Treas. Reg. § 1.856-4(b)(3).

27/ *See*, *e.g.*, *Moore Charitable Trust v. United States*, 9 F.3d 623 (7th Cir. 1993), petitioned 1994 U.S. Dist. LEXIS 1891 (1994), and acq. in part, 1994-2 C.B. 1; *Oblinger Trust v. Commissioner*, 100 T.C. 114 (1993); *White's Iowa Manual Labor Institute v. Commissioner*, T.C. Memo 1993-364 (1993).

28/ 1994-13 I.R.B. 5.

receive a share of rents received from subtenants.[29]

D. *Exclusion of Gains and Losses from the Sale of Property*

Section 512(b)(5) excludes from UBIT all gains and losses from the sale, exchange or other disposition of property other than (1) stock in trade or other inventory and (2) property held for sale in the ordinary course.

This UBIT exclusion covers gains and losses from the sale of capital gain assets, including investment assets such as stocks and land (provided the charitable trust is not considered to be a "dealer" with respect to such land, as discussed below). Interestingly, it also includes gains and losses from the sale of property used in an unrelated trade or business, provided that such property is not inventory; note, however, that in the case of property used in an unrelated trade or business, the depreciation recapture rules under Section 1245 may be applicable.

1. *Lapse or Termination of Options*

Section 512(b)(5) also excludes from UBIT the gains and losses associated with the lapse or termination of options to buy or sell securities or real estate, provided that such options are in connection with investment activities.[30]

2. *Special Issues in Connection with Sale of Land*

Section 501(c)(3) organizations, including charitable trusts, often receive contributions or bequests of large tracts of undeveloped land. When such organizations wish to dispose of their holdings in the land, they must plan carefully to avoid adverse UBIT consequences. By engaging in development activities before the sale, a charitable trust may be able to maximize the value of the land. Too much development, however, can convert a charitable trust into a dealer in land for tax purposes, subjecting gain from the sale of the property to UBIT. Case law and IRS rulings generally look to the income tax rules governing capital gains vs. ordinary income (dealer) property in determining whether the property is held primarily for sale "in the ordinary course of business." The IRS has issued several private letter rulings applying these rules in the context of charitable organizations seeking to dispose of large parcels of land.

a. *PLR 8950072*

In PLR 8950072 (Sept. 21, 1989), the IRS was asked to review four alternative uses of land held by a charitable foundation. The foundation had as its single largest asset a parcel of unimproved real property comprising some 260 acres. The property was leased at an annual rent of $100,000, which was the maximum amount available as rental for undeveloped property. In conjunction with professional consultants, the foundation identified four possible uses of the property:

(1) Continue the present leasing arrangement without change, bringing the foundation annual rental income of approximately $100,000.

(2) Sell the property, as is, for an estimated cash value of $4 million.

29/ *See*, *e.g.*, *Madden v. Commissioner*, T.C. Memo 1997-395 (1997).

30/ Treas. Reg. § 1.512(b)-1(d)(2).

(3) Complete preliminary development work (e.g., obtaining various permits and approvals) and sell the property in large blocks to a few developers before the construction of any improvements. The exempt organization's anticipated net income from this third alternative was $6 million.

(4) Assume all risks of development and manage the development and marketing process from start to finish. This would include design and construction of streets, curbs, gutters, sidewalks, lighting and utilities. The exempt organization would then subdivide the property and sell individual lots to the general public. The organization anticipated this approach would provide a much greater return on its investment than any of the other options.

The IRS concluded that the first three choices would not subject the organization to UBIT. Since the fourth possibility involved the exempt organization in extensive development and marketing activities, however, the IRS concluded it would result in UBIT.

b. *PLR 9340062*

In PLR 9340062 (July 16, 1993), the IRS again concluded that the sale of land by a Section 501(c)(3) organization would not be subject to UBIT. That ruling involved a foundation that owned certain unimproved farm and ranch land. By liquidating this low-yielding real estate, the foundation hoped to be able to make higher yielding alternative investments to meet its charitable goals.

To obtain a better price for its current holdings, the foundation entered into an arrangement with a real estate developer to buy additional land adjacent to its current holdings and then sell the entire parcel to the developer. The developer (not the foundation) was to negotiate the purchase of the adjacent property, and the foundation's purchase of the adjacent property was subject to the developer exercising a purchase option in its agreement with the foundation.

The developer intended to develop the entire parcel into a planned-use community. To complete the community, the developer planned to acquire additional land. The foundation did not have an interest in that additional land, although its approval of the developer's acquisition of the additional land was a condition to the foundation's purchase of the adjacent parcels of land and its proceeding with the transaction. Although the developer was responsible for the development of the land, the foundation did have approval rights over the overall development plan.

In ruling that any gain the foundation realized from the sale of the land would not be subject to UBIT, the IRS was persuaded by the following favorable factors:

(1) The property had been held for many years.

(2) The foundation's holdings had never been used for any purpose other than farming and ranching, and there were no improvements other than fencing.

(3) Instead of selling multiple properties to many different buyers, the foundation planned to sell property only to one buyer -- the developer -- in stages under an option agreement that anticipated no more than one sale per year and no fewer than one sale every three years.

(4) The foundation did not solicit buyers, advertise, improve or

subdivide its current holdings.

c. *Potential Application of Excess Business Holdings Rules*

Where the owner of the property is a private foundation, as in PLR 9340062, an additional concern is whether there is a violation of the excess business holdings rules under Section 4943. Those rules generally limit to a total of 20% the permitted ownership that a private foundation and all "disqualified persons"[31] together may hold in a "business enterprise."

A "business enterprise" includes the active conduct of a trade or business, including any activity that is regularly carried on for the production of income and constitutes an unrelated trade or business under Section 513.[32] The term "business enterprise" does not include a trade or business at least 95% of the gross income of which is derived from "passive sources." To the extent a private foundation receives income in the form of capital gains from the disposition of property, it does not have a Section 4943 excess business holdings problem. Conversely, if a private foundation holds property for sale in the ordinary course of business, it would apparently be holding an interest in a "business enterprise," the income from which would not be income from "passive sources." Thus, the foundation would have excess business holdings that would be subject to excise tax and divestiture under Section 4943.

d. *Planning Considerations*

While it is clear that an exempt organization that becomes extensively involved in the development, advertising, and sales processes subjects itself to a substantial risk of UBIT on the proceeds of the sale, there are ways for the organization to maximize its sale proceeds without triggering UBIT. For example, an exempt organization may engage the services of an independent real estate developer to design an overall plan for the development and sale of the property. That plan may require the organization to seek permission from the local regulatory bodies to subdivide the property, and perhaps make some minimal improvements to the property before it is sold.

The general rule is that the greater the extent of the physical improvements, the less likely it is that the sale will come under the exclusion for UBIT. However, the IRS has granted favorable UBIT treatment where some minimal physical improvements are made to the property before sale, particularly where those improvement are required by local regulatory authorities in order to sell the property.

Further, the sale of large parcels of land to a few parties, ideally to the developer, are preferable to the sale of many parcels to a number of parties. In addition, even if one or more unfavorable factors are present, evidence of one or more of the following favorable factors may outweigh the presence of the negative factors:

(1) The property was originally acquired by bequest or gift and was not acquired for resale purposes.

(2) The property was purchased for use in furthering the organization's exempt purposes.

31/ That is, substantial contributors, foundation managers, certain 20% owners, and members of the family of any of the foregoing. Sections 4943(d) and 4946(a).

32/ Section 4943(d)(3).

(3) The property has been used by the exempt organization in furtherance of its exempt purposes.

(4) The exempt organization has not sold off many other parcels of land prior to this particular sale.

E. *Income From Controlled Organizations: Section 512(b)(13)*

Although interest, rents, royalties and annuities are generally exempt from UBIT under the provisions set forth above, Section 512(b)(13) provides an exception for "specified payments" from "controlled organizations" to the extent that such amounts reduce the net unrelated income or increase the net unrelated loss of the controlled organization. "Specified payments" include interest, rents, royalties or annuities, but do not include dividend income. Under amendments made by the Taxpayer Relief Act of 1997, "control" is defined as:

1. in the case of a corporation, ownership by vote or value of more than 50% of the stock;

2. in the case of a partnership, more than 50% of the profits or capital interest in the partnership; and

3. in the case of any other entity, ownership of more than 50% of the beneficial interests.[33]

The amendments made in 1997 were intended to prevent exempt organizations from circumventing the application of Section 512(b)(13) by establishing second-tier subsidiaries to make the specified payments of interest, rent, royalties and/or annuities.

The distinction between the treatment of interest and dividend income can have a large impact where the classification of income is not clear. For example, if a CRT is funded with convertible debentures or bonds of a "controlled entity," the income could either be classified as interest income, which is subject to unrelated business income by reason of Section 512(b)(13), or dividend income, which is not affected by Section 512(b)(13).[34] If the issuing corporation has a high debt-to-equity ratio, then it is more likely that the debt will have to be satisfied out of the earnings of the corporation. In such a case, the IRS may reclassify the bond as stock, producing dividend income. Note that this distinction between dividend and interest income is only significant when dealing with controlled corporations.

Section 512(b)(13) subjects exempt organizations to tax on amounts derived from controlled subsidiaries, even where the amounts are determined at fair market value. This means, for example, that a charitable trust will be subject to UBIT if it leases office space to a for-profit subsidiary, but not if it leases the same space at the same rental rate to an unrelated third party. However, the 1999 Financial Freedom Act contained an amendment to Section 512(b)(13) which would apply a fair market value test to passive income received from controlled organizations. Under the amendment, an exempt organization would not be subject to UBIT on interest, rents, annuities or royalties received from a controlled entity if such amounts meet fair

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33/ Section 512(b)(13)(D)(i). In addition, the constructive ownership rules of Section 318 apply in determining whether an entity is "controlled."

34/ *See*, *e.g.*, Englebrecht et. al., "How Charitable Trusts Can Avoid Unrelated Business Income," 20 EST. PLAN. 226 (July/August 1993).

market value standards set out in Section 482. Any income in excess of the fair market value standard would be subject to a tax, plus a penalty. The Financial Freedom Act was vetoed, on other grounds, by the President in 1999. However, the amendment has considerable bipartisan support and may be reintroduced as part of future tax legislation.

IV. *Special Rules for Partnerships -- Section 512(c)*

Section 512(c) provides special rules applicable to exempt organizations that are partners in partnerships. In essence, Section 512(c) sets forth a "look through" rule to determine whether the activity of the partnership, if conducted directly by the exempt organization, would be an unrelated trade or business. If a charitable trust is a partner in a partnership that regularly carries on a trade or business that is unrelated with regard to the trust, then it must include its allocable share of all items of income and deductions from that partnership business in calculating its UBIT. Note that income must be included regardless of whether or not it was actually distributed. Both the income and deductions are subject to the Section 512(b) modifications discussed above. The partnership UBIT rules apply to both limited and general partners in partnerships. In *Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner*,[35] the Tax Court confirmed that the distinctions between limited and general partners are irrelevant for purposes of Section 512(c).

A. *Publicly Traded Partnerships*

For partnership years beginning before 1994, exempt organizations were subject to UBIT on all income from a "publicly traded partnership." The term "publicly traded partnership" was defined as any partnership in which either:

1. interests in the partnership were traded on an established securities market; or

2. interests in the partnership were readily tradable on a secondary market or the substantial equivalent thereof.[36]

B. *Example of Application of Section 512(c)*

"T", a trust exempt from federal income tax under Section 501(c)(3), is a 25% partner of a partnership ("P") that operates a spaghetti factory. The factory's business is unrelated with regard to T. Last year, P had $200,000 of gross income from the factory, with $100,000 deductions directly connected with running the factory. P also had $20,000 of passive rental income for the year. T's share of the factory income and deductions is $50,000 ($200,000 X 25%) and $25,000 ($100,000 X 25%), respectively. T must report this income and these deductions on Form 990-T. T's $5,000 share of the rental income ($20,000 X 25%) is excludable from unrelated business income. Therefore, T will be subject to the unrelated business income tax on $25,000 ($50,000 - $25,000).[37]

Note that if T were a charitable remainder trust, all of its trust income for the year would be subject to UBIT, not simply T's $25,000 actual unrelated business taxable income.

35/ 78 T.C. 812 (1982); aff'd 724 F.2d 519 (6th Cir. 1983), 53 A.F.T.R. 2d (RIA) 526 (1983).

36/ Section 469(k)(2).

37/ *See*, *e.g.*, Treas. Reg. § 1.512(c)-1.

V. *Special Rule for S Corporation Stock*

All stock held in an S corporation is considered an interest in an unrelated trade or business and all income derived therefrom will be subject to UBIT. Since charitable remainder trusts may not be shareholders of S corporations, this problem is inapplicable to them. However, now that charitable trusts exempt under Section 501(c)(3) organizations are permitted to be shareholders in S corporations,[38] it is important for them -- and their donors -- to understand that they are subject to UBIT on all income, loss or deductions related to S corporation stock, plus any gains or losses from the disposition of such stock.

VI. *Allocation of Expenses*

The subject of the allocation of expenses with respect to unrelated business income is extremely complex. The following is a summary of the basic principles:

A. *Directly Connected Expenses*

In computing UBIT, exempt organizations are allowed to deduct directly connected expenses, defined as expenses which have a proximate and primary relationship to carrying on the unrelated trade or business.[39]

B. *Dual Use Expenses*

Where services or facilities are used in both an exempt function activity and in an unrelated trade or business, the exempt organization must allocate expenses between these activities.[40]

C. *Exploitation of Exempt Activities*

Generally exempt organizations are not allowed to deduct exempt function expenses against unrelated business income.[41] There is a special rule, however, where the unrelated trade or business exploits the exempt function activity. In such cases, the exempt organization may apply exempt function expenses to offset the unrelated business income, subject to certain limitations.[42]

1. Exempt function expenses may be allocated against unrelated business income only where the unrelated activity exploits an exempt function, the unrelated activity is the type normally carried on by taxable organizations, and the exempt function is the type of activity normally carried on by taxable organizations.

38/ Section 1361(c)(6).

39/ Treas. Reg. § 1.512(a)-1(a).

40/ Treas. Reg. § 1.512(a)-1(c).

41/ Treas. Reg. § 1.512(a)-1(d)(1).

42/ Treas. Reg. § 1.512(a)-1(d)(2).

2. In these cases, deductions attributable to the exempt function activity may be applied to offset the unrelated business income to the extent that: (i) the aggregate of such expenses exceeds the income (if any) from the exempt activity; and (ii) the allocation of such excess will not produce a loss from the unrelated business income.

The purpose of this rule is to prevent an exempt organization from being subject to UBIT on an unrelated business income that is conducted as part of an exempt function activity, where the exempt function activity operates at a loss or produces a lower overall gain than the unrelated trade or business viewed in isolation. The rule recognizes, in these cases, that the unrelated trade or business could not be carried on without the exempt function activity, and that it would be unfair to tax the profits of that unrelated activity where the overall activity is less profitable or indeed operates at a loss.

VII. *Debt-Financed Income -- Section 514*

A. *Debt-Financed Property*

Income that would otherwise be exempt under the exclusions described above may nevertheless be subject to UBIT if such income is derived from debt-financed property. Such property is defined as property held to produce income, for which there is acquisition indebtedness at any time during the taxable year, or, if the property was disposed of during the taxable year, during the 12 months prior to the disposition.[43] "Property held to produce income" includes property held to produce dividends, interest, royalties and rents, as well as property held to produce gains upon disposition. Therefore, "income" includes not only passive forms of income, but also gains from the disposition of debt-financed property.[44]

B. *Exceptions to Debt-Financed Property and Income*

1. Property used in unrelated trade or business is not debt-financed property to the extent that income from the property is taken into account in computing the gross income of the unrelated trade or business.[45]

2. Property used to derive income from certain research activities is not debt-financed property.[46]

3. Property, substantially all of the use of which is substantially related to the exercise of an organization's exempt purposes, is not debt-financed property. "Substantially all" is defined by the regulations to mean that 85% or more of the property's use is devoted to exempt purposes.[47]

43/ Section 514(b)(1); Treas. Reg. § 1.514(b)-1.

44/ Treas. Reg. § 1.514(b)-1.

45/ Section 514(b)(1)(B); Treas. Reg. § 1.514(b)-1(b)(2).

46/ Section 514(b)(1)(C); Treas. Reg. § 1.514(b)-1(b)(4).

47/ Section 514(b)(1)(A); Treas. Reg. § 1.514(b)-1(b)(1).

If less than 85% of the property is devoted to exempt purposes, then the amount of income is allocated between the substantially related uses and the non-related uses. Only the non-related portion of the property is considered debt-financed.

4. Property used in a trade or business that is excluded from UBIT because it has a volunteer workforce, is carried on for the convenience of members, or consists of sales of donated merchandise is not debt-financed property.[48]

5. "Life income contract" arrangements are not debt-financed property. This exception applies to property transferred to a trust or fund subject to a contract providing that an income stream from that property will be paid to the transferor or other persons, where the remainder interest is payable to a Section 501(c)(3) organization. To the extent that the payments to the transferor do not constitute the proceeds of a sale or exchange of the transferred property, such property is not debt-financed property in the hands of the transferee trust or fund.[49]

6. Property acquired by an exempt organization for prospective exempt use is not debt-financed property if the exempt organization acquires real property with the intention of using it for exempt purposes within 10 years, such property is in the neighborhood of other property owned by the organization used for exempt purposes, and the organization does not abandon their intent to use the land for exempt purposes within the 10-year period. This exception is known as the "neighborhood land rule."[50]

7. Dividend income from a qualified REIT is excluded from UBIT even where the property held by the REIT is debt-financed.[51]

C. *Acquisition Indebtedness*

"Acquisition indebtedness" is defined as debt incurred by an exempt organization to acquire or improve property, debt incurred before the property was acquired if it would not have been incurred but for the planned acquisition, and debt incurred after the property is acquired if the debt would not have been incurred but for the acquisition of the property and the need for such debt was reasonably foreseeable when the property was acquired.[52]

1. *Mortgages*

If property is acquired subject to a mortgage or lien, the amount of the mortgage or lien will be considered an indebtedness of the organization, even if the organization did not assume or agree to pay the indebtedness.[53] However, if the property was acquired through a devise or gift, the indebtedness will not be treated as

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48/ Section 514(b)(1)(D); Treas. Reg. § 1.514(b)-1(b)(5).

49/ Treas. Reg. § 1.514(b)-1(c)(3).

50/ Section 514(b)(3)(A); Treas. Reg. § 1.514(b)-1(d).

51/ Rev. Rul. 66-106, 1966-1 C.B. 151.

52/ Section 514(c); Treas. Reg. § 1.514(c)-1(a)(1).

53/ Section 514(c)(2)(A); § 1.514(c)-1(b)(1)-(2).

acquisition indebtedness for the 10 years following the date of acquisition.[54] This devise and bequest exception does not apply if the organization assumed or agreed to pay the indebtedness in order to acquire the property given by bequest or devise, or if the organization makes any equity payments on the property owned by the decedent or the donor.[55]

2. *Annuity Obligations*

Certain obligations to make annuity payments are excepted from the definition of acquisition indebtedness.[56] Such obligations must meet the following criteria:

a. the obligation to pay the annuity was the sole consideration issued in exchange for property,

b. the value of the annuity is less than 90 percent of the value of the received property,

c. the annuity is payable over the life of one or two individuals in being at the time the annuity was issued, and

d. the annuity is payable under a contract which guarantees neither a maximum or minimum number of payments and does not provide for an adjustment of the amount of the annuity payment by reference to the income stream from the transferred property or any other property.

3. *Securities Loans*

If payments are received from securities loans, they are deemed to derive from the securities actually loaned and not from the collateral security or the investment of collateral security. An obligation to return collateral security is not treated as acquisition indebtedness.[57]

4. *Indebtedness Incurred in Performing Exempt Purpose*

If an organization incurs indebtedness which is "inherent" in the performance of its exempt purposes or function, this is not considered acquisition indebtedness.[58] Although several exempt trusts have attempted to characterize the purchase of securities "on margin" as being inherent in their exempt purpose of creating an

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54/ Section 514(c)(2)(B); Treas. Reg. § 1.514(c)-1(b)(3).

55/ For a more thorough discussion of funding CRTs with encumbered residential real property, see Hollis F. Russell, et. al., "Practical Guidance for Charitable Remainder Trust Planning Residential Real Property," 21 TAX. MGMT. EST., GIFTS & TR. J. 159 (1996).

56/ Section 514(c)(5); Treas. Reg. § 1.514(c)-1(e).

57/ Section 514(c)(8).

58/ Section 514(c)(4); Treas. Reg. 1.514(c)-1(d).

income stream, courts have consistently resisted this effort. *Bartels Trust v. United States*[59] confirms that purchasing securities on margin constitutes acquisition indebtedness and does not qualify for this exception.

5. *Commodity Future Transactions*

PLR 8104098 (Oct. 30, 1980) involved commodity futures trading by an exempt organization. The IRS ruled that the funds deposited in the margin account to purchase the futures do not give rise to acquisition indebtedness under Section 514 unless the funds are borrowed, and accordingly that commodity futures contracts are not debt-financed property.

D. *Application of Rules*

If an exempt organization receives income from debt-financed property, the portion of such income (less allocable expenses) subject to UBIT is the same percentage of total income as the property's debt is to its basis. This debt/basis ratio is recalculated every taxable year.[60]

For these purposes, "debt" refers to the property's "average acquisition indebtedness" which is the average amount of outstanding principal indebtedness during the taxable year. The amount is the aggregate of the outstanding principal on the debt on the first day of each month in the taxable year, divided by the number of months for which the property was held for the taxable year. The average adjusted basis is the average of the basis as of the first day of the taxable year and of the last day of the taxable year.[61]

Example: An exempt organization owns an office building that is debt-financed. It received $10,000 in rent for the taxable year. The average adjusted basis of the building is $100,000 and the average acquisition indebtedness is $50,000. The debt/basis ratio is 50%, so $5,000 of the rental income will be subject to UBIT.

E. *Planning Issues for Debt-Financed Income*

1. *Debt-financed Property in Partnerships*

Debt-financed income from a partnership retains its character when distributed to the partners. Therefore, exempt partners of partnerships that incur debt to acquire investment property will be subject to UBIT on their proportional share of partnership income.

In PLR 9651001 (June 27, 1996), an exempt organization held interests in two partnerships that owned debt-financed property. Instead of having the partnerships sell the property and distribute the gain which would be subject to UBIT, the exempt organization requested advice as to whether the sale of the partnership interests would avoid UBIT. The IRS ruled that the sale was subject to UBIT. Its reasoning was based on Section 751 which requires a "look through" of partnership interests to determine the character of the assets sold and the classification of the resulting gain. Therefore, the exempt organization could not avoid the application of the debt-financed rules by indirectly selling the partnership interest.

59/ Civ. No. 3-96-1018, 1998 U.S. Dist. LEXIS 15982 (D. Conn. 1998), aff'd 209 F.3d 147 (2d Cir. 2000).

60/ Section 514(a); Treas. Reg. § 1.514(a)-1.

61/ For details on calculating UBIT for debt-financed property, see Treas. Reg. § 1.514(a)-1(a)(2)-(3) and the examples thereunder.

2. *Using Foreign Subsidiaries to Avoid UBIT*

Last year the IRS issued PLR 199952086 (Sept. 30, 1999), which provides a planning opportunity for avoiding debt-financed income. The private letter ruling held that a charitable remainder unitrust did not have UBIT from debt-financed income passed through a foreign subsidiary. The CRUT requesting the ruling was the sole shareholder of a foreign corporation and was therefore required to include all of the corporation's "Subpart F income" (generally passive investment income) in its gross income. The CRUT proposed to transfer funds to its foreign subsidiary which would be used to purchase an interest in a U.S. partnership. The partnership managed a portfolio of below-investment-grade securities, some of which were acquired with debt financing. Therefore, some of the income of the partnership would be debt-financed income which it would distribute to the foreign corporation as its partner. The CRUT would in turn include its share of the foreign corporation's Subpart F income in its gross income.

The IRS ruled that the foreign subsidiary's distributive share of the partnership income, its actual distributed share of partnership income and the actual distributions to the CRUT were not subject to UBIT. The effect of this ruling was to allow the CRUT to avoid UBIT resulting from debt-financed income by using the intermediary of a foreign subsidiary.

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