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Unrelated Business Income Tax

By

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I. Introduction

The unrelated business income tax ("UBIT") is imposed on the unrelated business taxable income ("UBTI") of most exempt organizations, including foundations. Nevertheless, UBIT has not been a primary focus of private foundations. As more fully explained below, the excess business holdings rules prohibit private foundations from holding an interest in most business enterprises. Although investment activities generally constitute an unrelated trade or business, since the enactment of the UBIT provisions in 1950, certain types of investment income have been excluded. However, with the development of new investment instruments and increasing sophistication of investors, income from investment activities have raised, and undoubtedly will continue to raise, questions as to the application of the UBIT. Private operating foundations must take care to insure that their activities are not subject to UBIT. Finally, community foundations, which are classified as public charities and not subject to the excess business holding rules, may engage in activities that raised UBIT concerns.

II. Current Environment

A. Public Inspection of Form 990-T

The Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) requires that organizations described in section 501(c)(3) make available for public inspection any Form 990-T, *Exempt Organization Business Income Tax Return*, filed after August 17, 2006. In interim guidance, the IRS has provided that the same disclosure rules that apply to annual information returns, Form 990-PF, Form 990, and Form 990-EZ generally will apply to disclosure of Form 990-T until regulations are issued and effective. *See* Notice 2007-45, I.R.B .2007-22 (May 29, 2007). Organizations that file Form 990-T solely to request a refund of the telephone excise tax are not required to make Form 990-T available for public inspection. *Id.* The public inspection requirement does not change the underlying UBIT rules. However, by making section 501(c)(3) organizations' UBTI public, the disclosure requirement facilitates and perhaps encourages increased scrutiny of charities' UBTI. *See* Panepento and Williams**,** *A Question of Calculation: Many Charity Businesses Manage to Avoid Paying Federal Taxes,* The Chronicle of Philanthropy 36 (February 7, 2008) (article based on study of business practices of 91 charities based on examination of Form 990-T).

B. IRS Concerns

The IRS has identified the complexity of UBTI, the difficulty in determining whether activities are subject to UBIT, and the number of organizations reporting losses on Form 990-T as an area of concern in the charitable sector. *See* Testimony of Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division, IRS Before the Oversight Subcommittee of the House Ways and Means Committee (July 24, 2007) at http://www.irs.gov/charities/charitable/article/0,,id=139781,00.html. While the IRS' testimony focused primarily on business activities rather than investment activities, the IRS has also noted that a significant number of Forms 990 report exempt rental income and also report a mortgage payable, suggesting that debt-financed rental income is not being reported on Form 990-T.

C. Congressional Concerns

1. In a letter dated May 25, 2007 to the Secretary of the Treasury encouraging a redesign of the Form 990, Senator Max Baucus (D-MT), the Chairman of the Senate Finance Committee and Senator Charles Grassley, the Ranking Minority Member specifically noted concern about UBIT at http://finance.senate.gov/press/Bpress/2007press/prb052907.pdf.

2. In the September 2007, the House Ways & Means Committee and the Senate Finance Committee, in connection with hearings on taxation of hedge fund managers and offshore activities of hedge funds, requested testimony on application of the debt-financed income rules to exempt organization investments. Janne Gallagher, Vice President and General Counsel, Council on Foundations, and this author presented testimony favoring restricting the application debt-financed income rules. This was a favorable development in that there was an indication that some members of Congress believed that the debt-financed income rules may be too broad and should be reviewed. Representative Sander Levin (D-MI) introduced a bill that would have provided an exclusion from the debt-financed income rules for certain investments. Congress did not take any action on these issues in the last session.

III. Description of Law

A. Imposition of Tax

The Code imposes a tax at normal corporate or trust rates on the UBTI of most tax-exempt organizations. I.R.C. § 511. UBTI is defined as gross income (less directly connected expenses) derived from an "unrelated trade or business." I.R.C. § 512(a). An unrelated trade or business is defined as: (a) any trade or business; (b) that is regularly carried on; and (c) is not substantially related, aside from the need of the organization for funds, to the organization's exempt purpose. I.R.C. § 513(a).

B. Definition of "Trade or Business"

1. General Rule

The term "trade or business" has the same meaning for UBTI purposes that it has in section 162,[1] and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Treas. Reg. § 1.513-1(b). An activity will not be considered an unrelated trade or business unless the organization's primary motive is to earn a profit. *Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990).

2. Consistent Losses

An organization that engages in an unrelated activity that consistently results in losses may not be able to offset UBTI from other activities with those losses; the activity generating losses may not be a trade or business because the organization lacks a profit motive. *See id.* (social club's non-member sales not conducted with the requisite profit motive to constitute a trade or business and taxpayer was not permitted to use its losses from non-member food and beverage sales to reduce its UBTI from investment income).

3. Fragmentation Rule

In determining whether an activity is an unrelated trade or business, an activity will not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities that may or may not be "related" activities. Therefore, UBTI can arise even where an overall activity bears an overall relationship to an organization's exempt purposes. I.R.C. § 513(c). For example, the sale of advertising in an exempt organization's publications will be treated as a separate activity for purposes of the UBIT analysis. *See* Treas. Reg. § 1.513-1(b). Similarly, in the context of merchandising, an item-by-item analysis must be conducted to determine whether sales give rise to UBTI. *See* Rev. Rul. 73-105, 1973-1 C.B. 264.

C. Meaning of "Regularly Carried On"

1. General Rule

The Treasury regulations provide that, in determining whether a trade or business is regularly carried on, "regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued." Treas. Reg. § 1.513-1(c)(1).

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

2. Commercial Counterpart/Benchmark

Business activities "will ordinarily be deemed *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." *Id*. However, if the activities are of a type that a nonexempt business carries on year round, the conduct of such activities by an exempt organization over a period of only a few weeks should not cause the activities to be deemed "regularly carried on." *See* Treas. Reg. § 513-1(c)(2)(i). Thus, for example, the operation of a sandwich stand by a hospital auxiliary for only two weeks at a state fair does not constitute the regular conduct of a trade or business. *See id*. However, the operation of a commercial parking lot on Saturday of each week year round would constitute the regular operation of a business. *See id*.

3. Seasonal Activities

Where a non-exempt commercial organization would typically conduct a business of a particular type only on a seasonal basis, the conduct of a similar activity by an exempt organization during a "significant portion" of the season ordinarily constitutes the regular conduct of a trade or business. *See id*.

4. Intermittent Activities

According to the regulations, "exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive or promotional efforts typical of commercial endeavors." Treas. Reg. § 1.513-1(c)(2)(ii). Income producing or fund raising activities that last only a short period of time are not regularly carried on if they occur "only occasionally or sporadically." Treas. Reg. § 1.513-1(c)(2)(iii). The fact that such activities occur on an annually recurring basis should not change this result. *Id*. *See, e.g., National Collegiate Athletic Ass'n v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990); *Suffolk County Patrolmen's Benevolent Ass'n v. Commissioner*, 77 T.C. 1314 (1981), *acq*., 1984-2 C.B. 2.

D. Meaning of "Not Substantially Related"

1. Definition

Whether an activity is substantially related to an organization's exempt purposes is a fact-based inquiry that requires an examination of the relationship between the activity and the accomplishment of a particular organization's exempt purposes. *See* Treas. Reg. § 1.513-1(d)(1). The inquiry does *not* look to whether the activities compete with similar activities of non-exempt organizations. To be "related," the activities must have a "causal" relationship to the achievement of the organization's exempt purposes (other than through the production of funds). *See* Treas. Reg. § 1.513-1(d)(1)-(2). To be "substantially" related, the production of goods or performance of services from which the income is derived must "contribute importantly" to the accomplishment of the organization's exempt purposes, giving consideration of the size and extent of the activities involved. *See id*; Treas. Reg. § 1.513-1(d)(3).

2. Considerations of Scale

However, if activities that otherwise contribute importantly to the accomplishment of the organization's exempt purposes are conducted on a larger scale than is reasonably necessary for the performance of such functions, the portion of the income attributable to the excess will be considered income from an unrelated activity. *See* Treas. Reg. § 1.513-1(d)(3).

3. Relationship to Organization's Exempt Purposes

To be "substantially related," the activity must be related to the stated exempt purposes of the *particular exempt organization involved*. Therefore, even if an activity may serve a legitimate section 501(c)(3) charitable, educational or other purpose, if such purpose is not a stated purpose of the relevant organization, the activity will not be considered substantially related, and income from the activity may give rise to UBTI. *See* Rev. Rul. 73-105, 1973-1 C.B. 264 (sale of science books by an art museum is unrelated).

E. Exceptions to Definition of Unrelated Trade or Business

1. Volunteer Exception

Section 513(a)(1) excludes from the definition of "unrelated trade or business" activities in which substantially all of the work in carrying out the trade or business is performed without compensation, *i.e.*, by volunteers.

2. Convenience Exception

Also excluded are activities carried on by a Section 501(c)(3) organization (or college or university described in section 511(a)(2)(B)) "primarily for the convenience of its members, students, patients, officers, or employees." *See* I.R.C. § 513(a)(2); Treas. Reg. § 1.513-1(e)(2). For example, a laundry operated by a college for the purposes of laundering dormitory linens and the clothing of students would be considered an activity conducted for the convenience of the colleges students, and thus would not constitute an unrelated trade or business. *See* Treas. Reg. § 1.513-1(e) (flush language).

3. "Thrift Shop" Exception

Also excluded by statute from the definition of unrelated trade or business is the "selling of merchandise, substantially all of which has been received by the organization as gifts or contributions." I.R.C. § 513(a)(3). The regulations explain that this "exception applies to so-called 'thrift shops' operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization." Treas. Reg. § 1.513-1(e) (flush language).

4. Other Statutory Exceptions

The Code also provides for several other fairly narrow statutory exceptions from the definition of "unrelated trade or business." Of interest to some community foundations is the exception for qualified corporate sponsorship payments (*see* I.R.C. § 513(i)) which is discussed below.

F. "Passive Income" Exclusions

Certain types of income, commonly referred to as "passive income," are excluded from UBTI. I.R.C. § 512(b). These include dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, annuities, royalties, rents from real property and personal property leased with the real property if the rent attributable to the personal property is 50 percent or less of the total and the rent does not depend on income or profits derived from the leased property, and capital gains and losses. I.R.C. §§ 512(b)(1), (2), (3), and (5). The exclusions for dividends, interest, rents, and royalties were included when the UBTI provisions were first added to the law in 1950. The Senate Report provided:

> Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because . . . they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes *of these types* have long been recognized as a proper source of revenue for educational and charitable organizations.

S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31, *reprinted in* 1950 U.S.C.C.A.N 3053, 3083.

G. Unrelated Debt-Financed Income

The exclusions for passive income are not available for income derived from debt-financed property. I.R.C. §§ 512(b)(4); 514(a)(1). As described in more detail below, section 514(a)(1) requires an exempt organization to include in UBTI a percentage of income derived from "debt-financed property" equal to the "average acquisition indebtedness" for the taxable year over the average amount of the adjusted basis for the taxable year. A like percentage of deductions is allowed in computing UBTI. I.R.C. § 514(a)(2). The straight-line method of depreciation must be used. I.R.C. § 514(c)(3).

IV. Interaction with Excess Business Holding Rules

A. Overview

A private foundation's ability to operate an unrelated trade or business is limited by section 4943 which imposes an excise tax on "excess business holdings" of private foundations in a "business enterprise." The general rule is that the combined ownership of a private foundation and its disqualified persons of a "business enterprise" in any form is limited to 20 percent of the business. I.R.C. § 4943(c). A 35 percent limit applies in certain circumstances if the foundation can show that effective control is in a third party that is not a disqualified person. I.R.C. § 4943(c)(2)(B). The term unrelated trade or business refers to a business activity conducted by an exempt organization and, thus, the exempt organization is a 100 percent owner of such an activity. Because the excess business holdings rules prohibit a private foundation from owning 100 percent of a business enterprise, a private foundation cannot conduct an unrelated trade or business.

B. Definition of Business Enterprise

1. General Rule

A business enterprise is defined as the active conduct of a trade or business, including any activity that is regularly carried on for the production of income from the sale of goods or the performance of services. *See* Treas. Reg. § 53.4943-10(a)(1). This definition is the same as the basic definition of a trade or business for UBTI purposes. *See* I.R.C. 513(c). However, no part of a trade or business is excluded from classification as a business enterprise because it does not result in a profit. Treas. Reg. § 53.4943-10(a)(1). In contrast, as discussed above, for UBIT purposes, an activity that consistently results in losses may not be treated as an unrelated trade or business for UBIT purposes.

2. Passive Income Businesses

The term business enterprise does not include a business in which more than 95 percent of the gross income is derived from passive sources. I.R.C. 4943(d)(3)(B). For these purposes, passive sources are defined by reference to the exclusions from UBTI in sections 512(b)(1), (2), (3), and (5). The fact that income may be taxable as UBTI because of the unrelated debt-financed income rules does not affect its character as passive income for purposes of the excess business holdings rules. Treas. Reg. § 53.4943-10(c)(2). Thus, if 95 percent of the gross income of a business is derived from dividends, interest, royalties, annuities, certain rents, and gains on the sale or disposition of capital gain, it is not treated as a business enterprise for purposes of the excess business holdings rules. This is the result even if the income is subject to UBIT under the debt-financed income rules. In addition, income from the sale of goods is treated as passive if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods. I.R.C. § 4943(d).

3. Functionally Related Businesses

A "functionally related business" as defined in section 4942(j)(4) is not a "business enterprise." I.R.C. § 4943(d)(3)(A). The term "functionally related business" means (a) a trade or business which is not an unrelated trade or business (as defined in section 513), or (b) an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the charitable, educational, or other similar exempt purpose of the organization. Treas. Reg. § 53.4942(a)-2(c)(3)(iii). The regulations provide two examples:

> *Example (1).* X, a private foundation, maintains a community of historic value which is open to the general public. For the convenience of the public, X, through a wholly owned, separately incorporated, taxable entity, maintains a restaurant and hotel in such community. Such facilities are within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to X's exempt purpose. Thus, the operation of the restaurant and hotel under such circumstances constitutes a functionally related business.
>
> *Example (2).* Y, a private foundation, as part of its medical research program under section 501(c)(3), publishes a medical journal in carrying out its exempt purpose. Space in the journal is sold for commercial advertising. Notwithstanding the fact that the advertising activity may be subject to the tax imposed by section 511, such activity is within a larger complex of endeavors which makes available to the scientific community and the general public developments with respect to medical research and is therefore a functionally related business.

4. Program Related Investments

A "program related investment" as defined in section 4944(c) is not a "business enterprise." A program related investment is defined as an investment, the primary purpose of which is to accomplish one or more charitable purposes (as described in section 170(c)(2)(B)) and no significant purpose of which is the production of income or the appreciation of property.

C. Meaning of Interest in a Business Enterprise

1. Bonds

A bond or other evidence of indebtedness does not constitute a holding in a business enterprise, unless the holding is otherwise determined to be an equity interest. Treas. Reg. § 53.4943-10(a)(2).

2. Leasehold Interests in Real Property

A leasehold interest in real property does not constitute a holding in a business enterprise, even though rent payable under the lease is dependent, in whole or in part, on the income or profits derived by another person from the property, unless the leasehold interest constitutes on interest in the income or profits or an unrelated business under section 513. Treas. Reg. § 53.4943-10(a)(2).

V. Taxation of Non-Real Estate Investments

A. Passive Income Exception

As noted above, many types of investment income are excluded from UBTI. If the income is debt-financed, however, it is subject to UBIT to the extent it is debt-financed.

B. Unrelated Debt Financed Income

1. Amount Included in UBTI

Section 514(a)(1) requires an exempt organization to include in UBTI a percentage of income derived from "debt-financed property" equal to the "average acquisition indebtedness" for the taxable year over the average amount of the adjusted basis for the taxable year. A like percentage of deductions is allowed in computing UBTI. I.R.C. § 514(a)(2). All deductions allowable in computing taxable income are permitted in computing debt-financed income. I.R.C. § 514(c)(3).

2. Meaning of "Debt-financed Property"

Any property held to produce income with respect to which there is an acquisition indebtedness at any time during the taxable year or, if the property is disposed of during the taxable year, at any time during the 12-month period ending with the disposition. I.R.C. § 514(b)(1).

3. Meaning of "Acquisition Indebtedness"

The unpaid amount of indebtedness incurred: (i) by the organization in acquiring or improving debt-financed property; (ii) before the acquisition or improvement of the debt-financed property if such indebtedness would not have been incurred but for such acquisition or improvement; and (iii) after the acquisition or improvement of the debt-financed property if (1) that indebtedness would not have been incurred but for such acquisition or improvement and (2) incurring such indebtedness was reasonably foreseeable at the time of the acquisition or improvement. I.R.C. § 514(c).

4. Purpose and Effect

The debt-financed income rules were passed in 1969 to foreclose abusive sale-leaseback transactions. In such transactions, a charitable organization would acquire property (usually real estate) from a taxable business, often borrowing to finance the entire purchase price. As a condition of the sale, the exempt organization would lease the property back to the seller on a long-term basis. The exempt organization would repay the loan, plus interest, with the lease payments or "rental payments" received from the seller-lessee. The exempt organization would receive both (i) the difference between the "rental payments" and the sale price and (ii) outright title to the property, all without investing or risking much, if any, of its own funds. The seller would obtain capital gain treatment for the sale price received and large deductions against taxable income for the "rental payments" made, all while continuing to operate its business using the property in the same manner as before.

5. Challenges in Applying Rules to Non-Real Estate Investments

The debt-financed income rules have been challenging to apply to securities and other financial products. Neither the Code nor the Treasury regulations define "indebtedness" for purposes of the debt-financed income rules. Consequently, in determining whether a particular transaction creates indebtedness and therefore is subject to tax, the Internal Revenue Service and the courts have looked to common law definitions of indebtedness and definitions in other parts of the Code. The result has been that the rules have been applied in a formalistic manner. Generally, when a tax-exempt investor borrows funds and has a clear obligation to repay the funds, the debt-financed income rules are applicable. However, many investments that involve "leverage" but not a direct borrowing are not considered debt-financed property and are not subject to UBIT.

6. Leveraged Investments Subject to UBIT

a. Purchase of Stock or Securities on Margin

It is well established that the purchase of securities on margin gives rise to unrelated debt-financed income. *Elliott Knitwear Profit Sharing Plan v. Commissioner*, 614 F.2d 347 (3d Cir. 1980), *aff'g* 71 T.C. 765 (1979); *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (ND Ala. 1986*); Ocean Cove Corporation Retirement Plan v. United States*, 657 F. Supp. 776 (SD Fla. 1987); *Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*, 209 F.3d 147, 156 (2d Cir. 2000).

b. Repurchase Agreements

In a repurchase agreement, one party (usually a bank) purchases securities from another party (the bank's customer) and agrees to sell the securities back to the customer at an agreed price. Such transactions are treated as a loan of money secured by the securities and give rise to unrelated debt financed income. *See* Rev. Rul. 74-27, 1974-1 C.B. 24; Rev. Rul. 77-59, 1977-1 C.B. 196.

7. Leveraged Investments Not Subject to UBIT

a. Securities Lending Transactions

Section 514(c)(8) provides that payments with respect to securities loans are deemed to be derived from the securities loaned, not from collateral security or the investment of collateral security from such loans. Similarly, any deductions that are directly connected with collateral security for a securities loan, or with the investment of collateral security, are deemed to be deductions that are directly connected with the securities loaned. Finally, an obligation to return collateral security is not treated as acquisition indebtedness.

b. Short Sales of Stock

The Service has ruled that neither the gain attributable to the decline in the price of the stock sold short nor the income earned on the proceeds of the short sale held as collateral by the broker constituted debt-financed income. Rev. Rul. 95-8, 1995-1 C.B. 107.

c. Commodities Futures Transactions

In G.C.M. 39620 (Apr. 3, 1987), the Service concluded that gains and losses from commodity futures contracts are excluded from UBTI under Code section 512(b)(5). The Service concluded that the obligation of a holder of a long position to pay for the commodity on delivery did not constitute indebtedness because it was an executory contract and neither the seller for the buyer actually held the property at the time of entering into the contract. The purchase of a long futures contract entailed no borrowing of money in the traditional sense. Similarly, the Service found a short contract was merely an executory contract because there was no property held by the short seller that produced income and thus there could be no acquisition indebtedness.

d. Securities Arbitrage Transactions

The Service has also addressed complicated securities arbitrage transactions that take advantage of the differential between the value of a stock index futures contract and the value of stocks comprising the index. *See* G.C.M. 39615 (Mar. 23, 1987).

e. Notional Principal Contracts

The Service has issued regulations providing that all income and gain from notional principal contracts is excluded from UBTI. *See* Treas. Reg. § 1.512(b)-1(a)(1).

f. Options

Section 512(b)(5) excludes from UBTI all gains or losses recognized, in connection with an organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c).

C. Avoidance of Debt Financed Income for Securities

1. Blocker Corporations

Exempt organizations can avoid the debt-financed property rules by investing in debt-financed property through a foreign corporation in a country that does not impose an income tax. In Private Letter Ruling 9952086 (Sept. 30, 1999), an exempt organization held 100 percent of the stock in a foreign corporation that invested in a U.S. partnership holding debt-financed securities. The Service held that the dividends paid by the foreign corporation to the exempt organization were excluded from UBTI as dividends under section 512(b)(2) and were not debt-financed income because the exempt organization had not incurred debt to acquire its interest in the foreign corporation. This result is essentially the same result that the Service reached with respect to offshore captive insurance companies, PLR 8819034 (Feb. 10, 1988), which was reversed by the addition of section 512(b)(17)(A) to the Code, providing that foreign source insurance income is UBTI.

In a series of three private letter rulings, the Service again concluded that income received from a foreign corporation is tax-free investment income even if the foreign corporation borrows to invest in securities. PLR 200251016 (Sept. 23, 2002); PLR 200251017 (Sept. 23, 2002); PLR 200251018 (Sept. 23, 2002). In these rulings, a charitable remainder unitrust was a limited partner in M, which planned to form a wholly owned foreign corporation, N. N planned to invest in several different funds as principal for its own account. N planned to borrow from third parties to invest in these funds and the funds might also borrow in excess of the amount contributed to them in order to make investments. The ruling found the trust had valid business purposes for investing through a foreign corporation: that the use of N will give M more flexibility in disposing of investments; will provide M and the charitable remainder unitrust more insulation against potential liabilities; will position N to manage M's investments more efficiently; and will allow N to avoid generating UBTI to M and the charitable remainder trust and other exempt investors in M.

It is important to note that these rulings stand only for the proposition that a dividend paid by a corporation that is recognized as a separate entity will be excluded from UBTI under Section 512(b)(1). In order for this planning technique to avoid tax on debt-financed investments, it is critical that the foreign corporation, not only be located in a jurisdiction where it is not subject to local tax but also not be subject to United States income tax. The tax law governing U.S. taxation of foreign corporations is exceedingly complex and is beyond the scope of this outline. In general, however, a foreign corporation holding U.S. real estate is subject to U.S. tax and, thus, will not enable an exempt organization to avoid tax on debt-financed real estate investments in the United States. Moreover, in some circumstances, foreign corporations holding personal property may be subject to U.S. tax. The important point is that exempt organizations must be satisfied that the foreign corporation that is intended to serve as a "blocker entity" will not engage in activities directly or indirectly that will subject it to U.S. income tax.

2. Contractual Agreements

The unrelated debt-financed income rules can also be avoided through contractual arrangements. In private letter rulings, the Service has held charitable remainder trusts did not have unrelated debt-financed income when they had a contractual right to income based on an educational institution's endowment even though the endowment had some unrelated debt-financed income. The educational institution, which was the charitable beneficiary of the trust entered into a contract with the trust giving it a right "units" that were tied to the value of the institution's endowment. The units entitled the charitable remainder trust to periodic income equal to the payout rate of the institution's endowment and the units could be redeemed for amounts based on the value of the endowment. *See* Priv. Ltr. Rul. 200352017 (Oct. 3. 2003); Priv. Ltr. Rul. 200352018 (Oct. 3, 2003); Priv. Ltr. Rul. 200703037(Oct. 23, 2006); Priv. Ltr. Rul. 200703038 (Oct. 23, 2006).

The Service also ruled that a charitable lead trust could avoid unrelated debt-financed income through a similar contractual arrangement but later limited the application of the ruling to funds that had already been invested in the endowment through the contractual arrangement. *See* Priv. Ltr. Rul. 200352019 (granting ruling to charitable lead trust); Priv. Ltr. Rul. 200702036 (Oct. 17, 2006) (limiting the application of Priv. Ltr. Rul. 200352019). The clarifying ruling indicated that the Service is concerned about inappropriate benefits to non-charitable beneficiaries because in a charitable lead trust, the charity receives the income for a term of years and then a non-charitable beneficiary receives the remainder interest. The Service stated that it is studying whether a charitable lead trust should realize UBIT on the transaction.

VI. Taxation of Investments in Real Estate

A. Exclusion of Rental Income from UBTI

1. General Rule

The general rule is that rent from real property (but not personal property) is excluded in computing UBTI. *See* I.R.C. § 512(b)(3).

2. Mixed Leases

Special rules apply to “mixed leases” involving both real and personal property.

a. If rents attributable to personal property are less than 10% of the total rents (determined at the time the personal property is placed in service), all of the rents are generally excluded from UBTI. *See* I.R.C. § 512(b)(3)(A)(ii).

b. If rents attributable to personal property are more than 10% but not more than 50% of the total rents, only rents attributable to real property are excluded. *See* I.R.C. § 512(b)(3)(i).

c. If rents attributable to personal property are more than 50% of the total rents, none of the rents are excludable. *See* I.R.C. § 512(b)(3)(B)(i).

d. If separate leases are entered for real and personal property but the properties have an integrated use, all leases will be considered a single lease for purposes of determining the amount attributable to personal property and real property, respectively.

3. Personal Services

Income from the occupation of space, when personal services are also provided to the occupant (*e.g.*, hotel rooms), does not constitute rent from real property. Treas. Reg. § 1.512(b)-1(c)(5). Generally, services are considered rendered to the occupant if they are for his or her convenience and are not those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. Many exempt organizations lease space during times that the organization is not using it. This can be an excellent source of revenue, but exempt organizations must be careful not to provide services that will cause the rental income to be taxable. Several examples follow.

In Rev. Rul. 80-298, 1980-2 C.B.197, an exempt university leased its stadium to a professional football team for several months each year and furnished the utilities, playing field maintenance, dressing room, linen, and stadium security services. The Service ruled that the income from the lease was not excluded from UBTI because the playing field maintenance, dressing room, linen and security services were substantial services that went beyond those customarily rendered in connection with the rental of space for occupancy only.

In contrast, arranging for parking and maintaining the grounds surrounding a building is not an impermissible service. *Madden v. Commissioner,* 74 T.C.M. (CCH) 440 (1997). In *Madden,* a museum leased an outdoor theater to a performing arts organization and contracted with a landscaping company to maintain the grounds surrounding the theater. Under the lease agreement, the museum was obligated to arrange for 5,000 parking spaces. To fulfill this obligation, the museum entered into parking license agreements with owners of nearby buildings. The court held that the provision of maintenance services and the parking arrangements were not impermissible services for purposes of Treas. Reg. § 1.512(b)-1(c)(5). The court, however, held that the rent received by Museum from leasing the theater was subject to UBIT because the amount of the rent was based, in part, on net profits. (See discussion below on contingent rents.)

In TAM 9702003 (Aug. 28, 1996), an organization rented its facilities to third parties for special events. The organization provided personnel to set up and operate equipment and purchased liquor (because it held the liquor license). The third party arranged for catering. The Service held that the income received did not qualify for the exclusion for rents because of the provision of services.

4. Rent Contingent on Income or Profits

The exclusion for rents does not apply if the amount of rent depends on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage of sales. *See* I.R.C. § 512(b)(3)(B)(ii).

B. Unrelated Debt-Financed Income

1. General Rule

As discussed above, passive income such as rents which is generally excluded from UBTI is subject to tax to the extent that it is debt-financed.

2. Statutory Exceptions and Exclusions

The primary target of the debt-financed income rules is investment income rather than income from an exempt organization's conduct of its exempt functions. Accordingly, the Code contains a number of exceptions for property that is used by or acquired by an organization in the conduct of its exempt functions and for indebtedness that exempt organizations may commonly incur that is not inconsistent with their exempt purposes. While some of the exceptions are straightforward, others contain rules that can be the proverbial "trap for the unwary."

a. Substantially Related Use

Property is not treated as debt-financed if substantially all the use to which it is put is substantially related to the organization's exempt purpose. In general, an organization qualifies for this exception if 85% or more of the property is devoted to the organization's exempt purpose. Treas. Reg. § 1.514(b)-1(b)(1)(ii). The extent to which property is used for a particular purpose is determined by all the facts and circumstances. These may include a comparison of time that property is used for exempt purposes and other purposes, or a comparison of the portion of property that is used for exempt purposes and other purposes.

b. Neighborhood Land Exception

The neighborhood land exception is a special rule for exempt organizations that acquire nearby land for future use. Because the land is not immediately used for substantially related purposes, it would not qualify under that exception. Advisors of organizations acquiring land that they expect to qualify under this section should fully familiarize themselves with these rules to ensure compliance with those requirements. *See* I.R.C. § 514(b)(3); Treas. Reg. § 1.514(b)-1(d).

c. Property Acquired by Bequest, Devise, or Gift

Where property is acquired subject to a mortgage or other lien, the amount of indebtedness secured by the mortgage or lien is treated as acquisition indebtedness even if the organization did not assume or agree to pay for such indebtedness. I.R.C. § 514(c)(2)(A). However, in Revenue Ruling 76-95, 1976-1 C.B. 172, the Service held that an organization had no acquisition indebtedness when it acquired an undivided interest in rental property subject to a mortgage but prepaid its proportionate share of the mortgage indebtedness, and received releases of liability from the mortgagee and co-owners. If mortgaged property is acquired through a bequest or devise, the indebtedness is not treated as acquisition indebtedness for ten years. I.R.C. § 514(c)(2)(B). If it is acquired by gift, it is not treated as acquisition indebtedness for ten years if the property was held by the donor for more than five years prior to the date of the gift and the mortgage was placed on the property more than five years before the date of the gift. This ten-year exception does not apply if, in order to get the bequest, devise, or gift, the organization agreed to assume the indebtedness or the organization makes any payment for equity in the property. *See* PLR 9431001 (Feb. 1, 1994) (organization solicited donation of debt-financed property as part of fundraising drive and resold it).

C. Avoiding Unrelated Debt-Financed Income on Real Estate Investments

1. Real Estate Investment Trust (REIT)

a. In General

A real estate investment trust, commonly referred to as a REIT, is a corporation that makes passive investments in real estate and is not taxed at the entity level to the extent it distributes its profits to its shareholders. It can be an attractive investment for exempt organizations because investments in debt-financed property through a REIT generally do not result in UBTI for exempt organizations. *See* Rev. Rul. 66-106, 1966-1 C.B. 151.

b. Requirements

There are a number of requirements that some exempt organizations may not find acceptable. For investors willing to give up a certain amount of control, however, a REIT can be an attractive way to avoid the tax on debt-financed real estate investments.

(i) For example, by definition, a REIT must have 100 or more shareholders, I.R.C. § 856(c)(5), a requirement that makes it difficult for any single shareholder to exercise much control over investment decisions.

(ii) Moreover, section 856(h)(3) provides for recharacterizing a portion of dividends received from REITs to the extent that their income would be UBTI, if the REIT is "predominantly held by qualified trusts." A REIT is predominantly held by qualified trusts if (1) at least one qualified trust holds at least a 25% interest in the REIT or (2) one or more qualified trusts, each of which holds ore than a 10% interest in the REIT, collectively hold more than 50% of the interests in the REIT. I.R.C. § 856(h)(3)(D)(ii). Thus, the rules adopt a look-through approach for UBTI if one or a small group of qualified trusts own sufficient interests to direct the activities of the REIT.

(iii) Further, a prohibition against REITs being closely held generally would prevent exempt organizations described in section 501(c) from controlling a REIT. Generally, under section 856(h), more than 50% of the REIT cannot be held by five or fewer shareholders.

2. Segregated Investment Trusts and Segregated Asset Accounts

Similarly, segregated investment trusts provide a way to avoid the debt-financed property rules. In 1980, when pension funds lobbied Congress for an exception to the debt-financed property rules, one of the arguments they made was that the debt-financed property rules did not apply to common trust funds maintained by banks and segregated asset accounts maintained by insurance companies, and that this created a competitive imbalance. *Five Misc. Tax Bills: Hearings on S. 650 Before the Subcommittee on Taxation and Debt Management of the Senate Finance Comm.*, 96th Cong., 295 (1980). The regulations under section 584 were subsequently amended to provide that the debt-financed character of property held by a common trust fund "passed through" to the fund's beneficiaries. *See* Treas. Reg. § 1.584-2(c)(4) (Ex. (vi)). In 1984, Congress gave the Treasury Department regulatory authority to prevent the circumvention of section 514 through segregated asset accounts, but no regulations have yet been promulgated. *See* Tax Reform Act of 1984, P.L. 98-369, § 1034(b), 98 Stat. 494, 1039 (1984).

3. Blocker Corporations

Blocker corporations will not shield debt financed real estate investments from UBIT because a foreign corporation holding U.S. real estate is subject to U.S. tax. I.R.C. §897.

VII. Corporate Sponsorships

A. Overview

As a general rule, advertising is subject to UBIT but acknowledgement of donations is not subject to UBIT. In practice, it is difficult to draw a bright line between advertising and acknowledgement of donations. The safe harbor for qualified sponsorship payments provides detailed rules concerning activities in which an exempt organization can invest without being subject to tax.

B. Qualified Sponsorship Payments

Section 513(i) provides that a qualified sponsorship payment (a "QSP") is not included in UBTI. A QSP is a payment made to an exempt organization by a person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the exempt organization's activities. I.R.C. § 513(i)(2)(A). As section 513(i) is a safe harbor, a payment that is not a QSP may be excludable from UBTI under a different theory or provision. At the heart of the definition of a QSP is whether the payor has received a "substantial return benefit."

C. Use or Acknowledgement

Use or acknowledgement, as defined in the Code and regulations, is not a substantial return benefit. Use or acknowledgment may include:

1. logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company;

2. a list of the payor's locations, telephone numbers or Internet address;

3. value-neutral descriptions including displays or visual depictions, of the payor's product-line or services; and

4. the payor's brand or trade names and product or service listings. Treas. Reg. § 1.513-4(c)(2)(iii). A promotional logo or slogan that is an established part of the sponsor's identity does not, by itself, constitute advertising. Treas. Reg. § 1.513-4(c)(2)(iv).

D. Advertising

In contrast, advertising for the payor is a substantial return benefit and generally will cause the payment to be taxable to the exempt organization. Advertising is any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement or other inducement to purchase, sell or use a sponsor's facility, products or services. Treas. Reg. § 1.513-4(c)(2)(v).

E. Contingent Payments

If a payment or the amount paid is contingent upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity, it is not a QSP and will be taxable income to the exempt organization receiving it, unless it is excludable from income under another theory or provision. I.R.C. § 513(i)(2)(B)(i); Treas. Reg. § 1.513-4(e)(2).

F. Disregarded Benefits

Benefits received by a sponsor are disregarded and thus the sponsor has not received a substantial return benefit if the aggregate fair market value of all the benefits provided by the exempt organization do not exceed two percent of the amount of the payment. Treas. Reg. § 1.513-4(c)(2)(ii). If the value of the benefits exceeds two percent of the payment, then the entire fair market value of the benefit is treated as a substantial return benefit. *Id.* Benefits include advertising, exclusive provider arrangements, goods, facilities, services, or other privileges, and the right to use an intangible asset. Treas. Reg. § 1.513-4(c)(2)(iii).

G. Payment in Excess of Return Benefit

If a corporate sponsor receives a substantial return benefit, but its payment to the exempt organization exceeds the fair market value of the benefit received, then the excess of the sponsorship payment over the fair market value of the benefit received by the corporate sponsor is treated as a QSP. Treas. Reg. § 1.513-4(d)(1).

H. Periodicals

1. Safe Harbor Not Applicable

The safe harbor for a QSP does not include any payment which entitles the payor to the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in a periodical, which is defined for these purposes as "regularly scheduled and printed material published by or on behalf of the [exempt] organization and that is not related to and primarily distributed in connection with a specific event conducted by the [exempt] organization…." I.R.C. § 513(i)(2)(B)(ii)(I). Thus, newsletters will generally be treated as periodicals.

2. Determining Tax Treatment of Income from Periodicals

Whether revenue from periodicals is advertising or sponsorship income, related income, or some other form of income, must be determined under general principles of tax law. If the revenue is from advertising, then it is includable in UBTI. In most instances, advertising in a periodical is treated as UBTI, but the Supreme Court has left open the possibility that advertising could be related. *See United States v. American College of Physicians,* 475 U.S. 834 (1989). Moreover, a corporate sponsor might underwrite a series in a periodical or a particular article and not receive any return benefit other than an acknowledgement of its contribution. While this would not be governed by section 513(i), depending upon the facts and circumstances, it could be considered a sponsorship rather than advertising.

3. Calculation

The calculation of UBTI is governed by special rules for periodical advertising. In general, these rules permit the exempt organization to offset income earned from advertising with losses on the editorial side. *See* Treas. Reg. § 1.512(a)-1(f). These rules are intended to put periodicals published by exempt organizations on a level playing field with periodicals published by for-profit companies. Subscription prices for periodicals of for-profit companies are typically heavily subsidized by advertising revenue. Because the entire publication is taxed as one unit, the income from advertising is offset by losses on the editorial pages in the computation of taxable income by a for-profit company. If exempt organizations were not allowed to offset advertising income with readership losses, they would be taxed more heavily than comparably situated for-profit periodicals.