

FEDERAL INCOME TAXATION OF INVESTMENTS BY NONPROFIT ORGANIZATIONS: BEYOND A PRIMER*

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I. INTRODUCTION

The commercial transformation of the nonprofit sector has been widely chronicled.¹ The conventional wisdom is that a trend is in progress. To replace and augment traditional sources of revenue, more and more nonprofits are said to be straying from their stated mission by mimicking their for-profit brethren. This is hardly a new phenomenon. Over 50 years ago, before there was an unrelated business income tax, the popular press warned of the evils of commercialism. A December, 1948 front-page story in the New York Times described how universities were being used as tax shelters for business profits.² Two years later, an article in Fortune magazine was titled with the exhortation: "The Abuse of Tax Exemption: It Has Got to the Point Where Something Has to be Done About It."³ And, of course, there was New York University, best known for its ownership of the nation's largest producer of macaroni and noodles, as well as Howes Leather Company, American Limoges China, and Ramsey Corporation, a manufacturer of piston rings.⁴ Similar headlines today tell us about the slick museum shop

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¹See generally Burton A. Weisbrod (ed.), *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* (1998).

²Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, N.Y. TIMES, Dec. 13, 1948, at A1, A29.

³FORTUNE, May 1950, at 74.

⁴For more on this early history, see Donald L. Sharpe, *Unfair Business Competition and the Tax on*

at the suburban shopping mall, the millions to be earned by the American Medical Association for endorsements of heating pads and vaporizers, the Bishop Estate's major stake in Goldman Sachs, alliances with for-profit firms forged by research universities, health care providers, and even the National Geographic Society, and the proliferation of Dot Com subsidiaries.⁵

Nonprofit endowments also are enjoying tremendous growth, and the rich are getting richer. A study by the Spectrem Group, a financial consulting firm, estimates that charitable endowment assets have climbed to nearly \$600 billion.⁶ According to the latest tabulation by Cambridge Associates for the National Association of College and University Business Officers, the 509 educational institutions participating in the survey reported endowment assets totaling \$195.4 billion as of June 30, 1999, with Harvard topping the list with \$14.3 billion⁷ -- an enormous endowment that had climbed to \$19.2 billion by mid-2000.⁸ The Foundation Center estimates that the total assets held by U.S. private foundations reached \$385.1 billion by the end of 1998.⁹ This vast wealth is not limited to

Income Destined for Charity; Forty-Six Years Later, 3 FLA. TAX REV. 367, 380-383 (1996).

⁵See, e.g., Diane Brady, *When Nonprofits Go After Profits*, BUSINESS WEEK, June 26, 2000, at 173.

⁶See Thomas J. Billitteri, *Endowment Assets Nationwide Climb to Nearly \$600-Billion, New Study Finds*, CHRON. PHILANTHROPY, June 15, 2000, at 45.

⁷1999 NACUBO ENDOWMENT STUDY 1 (Cambridge Associates for the National Association of College and University Business Officers 1999) [hereinafter 1999 NACUBO Study]. University endowment wealth is highly concentrated, with only 129 (26%) of survey participants having endowment assets over \$300 million yet controlling over 80% of the total. Thirty-four institutions (7%) with endowment assets in excess of \$1 billion control over 50% of the total. *Id.*

⁸David Abel, *Harvard Endowment Zooms a Third to 19.2 B*, BOSTON GLOBE, Sept. 23, 2000, at F1. The \$4.8 billion increase for the 2000 fiscal year (a 32.2% total return for the fiscal year as compared to 7.3% for the S & P 500 index) was itself larger than the entire endowments of most private universities in the United States. Venture capital investments were a major contributor to Harvard's success.

⁹FOUNDATION CENTER, FOUNDATION YEARBOOK 2000.

foundations and elite universities. The Bishop Estate, long Hawaii's largest private landowner, reportedly has charitable and investment holdings estimated to be worth about \$6 billion,¹⁰ and the Howard Hughes Medical Research Institute's endowment reached \$11.7 billion by the end of its 1999 fiscal year.¹¹ Not included in these totals are tax-exempt qualified pension funds, which in one recent count were estimated to have \$7.3 trillion of total assets,¹² or churches. Tax-exempt institutional investors (including pension funds) are said to control 42% of the top 1,000 companies in the United States.¹³

Despite the fact that the unrelated business income tax (hereinafter "UBIT") is celebrating a milestone 50th birthday this year, virtually none of the income derived from this huge pool of wealth is subject federal or state tax. This generous tax holiday presumably is faithful to Congressional intent. When the UBIT was enacted, a critical distinction was drawn between business and investment activities. In overturning the destination of income test, Congress sought to tax the net income of a "trade or business" that was regularly carried on and not substantially related to the exempt purposes of an otherwise tax-exempt organization. The primary stated objective of the UBIT "was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business

¹⁰See Evelyn Brody, *A Taxing Time for Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAWAII L. REV. 537, 551 (1999).

¹¹See the Institute's annual report at <<http://www.hhmi.org/annual99/a440.html>>.

¹²Christine Williamson, *Slight Bump: Managers' Assets Barely Rise in 1999; Still, Tax-Exempt Funds Top \$7 Trillion*, 28 PENSIONS & INVESTMENTS 1 (May 1, 2000).

¹³*Reversal of Fortune: Institutional Ownership is Declining*, INVESTOR RELATIONS BUSINESS, May 1, 2000.

endeavors with which they compete."¹⁴ Investment activities, by contrast, were considered proper forms of behavior for nonprofit organizations, and thus traditional sources of passive investment income, such as dividends, interest, rents, and capital gains, generally were excluded from the UBIT tax base. Unlike profits from an unrelated trade or business, investment income was viewed more favorably as supporting the exempt purposes of charitable organizations -- a means rather than an end.¹⁵

Other presenters at this conference, thankfully, will examine the challenging theoretical and public policy issues surrounding the UBIT, and will delve more deeply into the poorly tailored rules governing unrelated debt-financed income. The purpose of this paper is to revisit the dichotomy between business and investment by providing a contemporary survey of the federal income tax treatment of charitable investments. Part II begins the inquiry by examining how the business/investment distinction has been drawn under general income tax principles and for certain specialized tax regimes outside the tax-exempt sector. Part III describes the evolution of nonprofit investors from their primitive roots under the Prudent Man Rule to their embrace of Modern Portfolio Theory, and provides a primer (and more) on the taxation of investment income under the UBIT. It reveals that exempt organizations are engaging in a much wider variety of income-producing activities, many of which were not even a blip on the Congressional

¹⁴Treas. Reg. § 1.513-1(b).

¹⁵As the UBIT matured, some exceptions to this policy emerged -- e.g., taxation of the investment income of § 501(c)(7) social clubs and § 501(c)(9) voluntary employee beneficiary associations, and a few other mutual benefit organizations, and the inclusion of income from debt-financed property. *See* I.R.C. §§ 512(a)(3), 514.

radar screen when the UBIT was first enacted. And Part III confirms a widely held view that the UBIT has virtually become a voluntary tax, narrow in scope and easily avoidable. Part IV addresses complex structures, such as corporate subsidiaries and joint ventures, that are the vehicles of choice for much of the nonprofit sector's entrepreneurial activity. Part V touches upon a few loose ends of general interest or particular interest to the author, and Part VI offers some concluding observations.

At the outset, a few disclaimers and disclosures are in order. In the spirit of past conferences, this paper is a somewhat bulky work in progress, eager to be further informed by the able commentators and others attending. It has been written by a full-time academic who unashamedly remains a tax generalist in a world of micro-specialization and who only recently, by necessity, has embarked on a study of investment theory and practice.¹⁶ As such, I have enough general knowledge to be dangerous but insufficient expertise in some of the nooks or crannies (e.g., Subpart F and equity index swaps, to name just two) that this paper nonetheless has chosen to address. My efforts to climb up the learning curve have been enriched by informal conversations with a number of investment community insiders who shall remain nameless here for privacy reasons and to exonerate them from any technical foot faults or greater transgressions for which I remain solely responsible.¹⁷

¹⁶In my spare time, I serve as an advisor to and officer of a family (not mine) private foundation and a fiduciary for funds that ultimately will pass to charity. Although I have made every effort to approach this paper from an academic perch, my perspective may have been influenced subliminally by my part-time role as tax advisor and charitable fiduciary. I have no conscious private agenda.

¹⁷And one final consumer warning. The paper as submitted is an unabridged version, containing too much descriptive background for its initial audience of cognoscenti but perhaps not enough for those uninitiated in the technicalities of tax law, investments, or both. Ideally and ultimately, it will reach a wider

II. DISTINCTIONS BETWEEN BUSINESS AND INVESTMENT ACTIVITIES: DRAWING LINES UNDER GENERAL INCOME TAX PRINCIPLES

A. A Normative Income Tax Base: Ideal and Actual

We begin with a few simple stipulations: (1) an income tax is the most appropriate method of raising revenue, (2) subject to a realization requirement, a taxpayer's gross income is broadly defined to include all accessions to wealth, including gains from dealings in property and windfalls, (3) a normative tax base should allow deductions for the ordinary and necessary costs of producing the income, and (4) the appropriate taxable period is one year. We might go further and stipulate that all income should be taxed at the same rate (whether flat or progressive) with no special preference for long-term capital gains. For purposes of this discussion, assume we are not concerned with a host of other issues, such as the deductibility of personal expenses and the business v. personal borderline, defining the taxable unit, and timing. In this simplistic world just described, it should not be necessary to draw lines between business and investment activities. If they have the requisite profit motive, taxpayers engaged in any type of income-producing activity would be taxable on all their income, and they could deduct the legitimate costs of producing that income.

Life is not so simple under our current federal tax system. In the for-profit world, numerous distinctions are made by the Internal Revenue Code between business and investment activities. Some bright (and fuzzy) lines are drawn to provide an incentive or subsidy for particular taxpayer behavior, or to determine whether income even should be

audience, who may benefit from a foundation of understanding of what is obvious to many of us.

subject to tax. Other lines are designed to prevent real and perceived abuses. Some distinctions are based on the policy of a particular income tax regime, such as the U.S. taxation of foreign persons and income, while other boundaries are not well grounded in any coherent policy. And in some cases, the line between business and investment is drawn only to be erased.

Before turning to line drawing problems under the UBIT, it seems appropriate to examine how business and investment activities are differentiated under general tax principles, why or whether it matters, and what all of this may or may not reveal about the proper scope and application of the UBIT. What follows is a selective survey designed to provide sufficient foundational background without degenerating into a Westlaw/Lexis dump of random cases and statutes.¹⁸ It remains to be seen whether it will advance the UBIT inquiry still to come.

B. Trade or Business v. Investment: In General

1. The Supreme Court's Definition of "Trade or Business"

Based on a LEXIS search, the term "trade or business" appears 347 times in the Internal Revenue Code and over 750 times in the regulations, but without any clear definition. The nerve center of the "trade or business" concept is § 162,¹⁹ which allows a

Sophisticated readers are thus encouraged to skim, omit or shred, as appropriate to their circumstances, knowing that the author did not intend to insult their intelligence.

¹⁸For earlier surveys lamenting the Code's failure to provide a uniform definition of "trade or business," see F. Ladson Boyle, *What is a Trade or Business?*, 39 TAX LAWYER 737 (1986); John H. Saunders, "Trade or Business," *Its Meaning Under the Internal Revenue Code*, 12 U.S.C. TAX INSTITUTE (MAJOR TAX PLANNING) 693 (1960).

¹⁹Unless otherwise indicated, "§" references in the text are to the Internal Revenue Code of 1986, as

deduction for the ordinary and necessary expenses paid or incurred "in carrying on any trade or business." For UBIT purposes, a "trade or business" includes any activity carried on for the production of income from the sale of goods or performance of services,"²⁰ and the regulations provide that "trade or business" has the same meaning as it has in § 162.²¹ So examining how the Supreme Court has defined the concept in this deduction setting and related areas is a natural starting point.

The Court periodically has been called upon to interpret "trade or business," and from the earliest days of the tax law it has distinguished between business and investment activities. In *Snyder v. Commissioner*²² the Court paused to consider whether an employee of an insurance company who also speculated in securities was engaged in a trade or business in connection with his trading activities.²³ In finding that the taxpayer did not devote a major or even substantial part of his business day to stock trading and did not "make his living" in buying and selling securities, the Court observed in dicta that the record would not support a finding that the taxpayer's activities constituted a trade or business. This early case suggests that a trade or business requires not merely a profit-seeking activity but a substantial if not almost full-time commitment by the seeker.

Five years later, the Court considered whether Pierre du Pont could deduct

amended.

²⁰I.R.C. § 513(c).

²¹Treas. Reg. § 1.513-1(b).

²²295 U.S. 134 (1935), *reh'g denied*, 295 U.S. 769 (1935).

²³The momentous issue in *Snyder* was whether the taxpayer, in computing his gains and losses on the sale of stock purchased throughout the year, could depart from the generally applicable first-in, first-out method of determining the basis for shares sold that were incapable of identification by specific certificates. The taxpayer argued that the FIFO basis convention did not apply to him because he was in a trade or business of buying and selling stocks.

payments made to reimburse a family holding company for dividends and related taxes on du Pont stock that he borrowed from the holding company and then resold to du Pont company executives who wanted a stake in the business. Noting that Mr. du Pont's "business was primarily that of conserving and enhancing his estate," the Court assumed that he was carrying on a trade or business but disallowed the claimed deductions because they were not "ordinary" in that they "arose out of transactions which were intended to preserve his investment in the corporation," and "[t]he well established decisions of this Court do not permit any such blending of the corporation's business with the business of its stockholders."²⁴ The Court's assumption undercut its earlier definition in *Snyder* and would suggest that any wealthy person who incurs legitimate expenses to conserve and enhance her wealth would be engaged in a business. This apparently troubled Justice Frankfurter, who concurred but questioned the Court's assumption that du Pont was conducting a trade or business. He observed that "'carrying on any trade or business' involves holding one's self out to others as engaged in the selling of goods or services."²⁵ Although this was dictum in a concurring opinion, Frankfurter's "holding out" concept for a time became more influential than the majority's broader view of "trade or business." The "Frankfurter gloss," as it became known, is a good description of the vast majority of businesses, but it ultimately proved to be too narrow. It excludes, for example, employees working for a single employer, and is inconsistent with subsequent case law holding that performing services as an employee does constitute a trade or business for purposes of

²⁴308 U.S. at 494.

²⁵*Id.* at 499.

§ 162.²⁶

The next and seminal case was *Higgins v. Commissioner*,²⁷ where the Court held that a taxpayer who devoted a considerable portion of his time to oversight of extensive real estate and securities holdings and hired others to assist him in rented office space was not carrying on a trade or business and thus could not deduct the legitimate expenses of this concededly profit-seeking activity. The taxpayer argued that the level and continuity of his "family office" activity differentiated him from the small investor, while the government's hard line was that "mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy."²⁸ After reviewing the history of the statutory predecessor to § 162, the Court sustained the Commissioner's position that managing one's own securities investments can never be a trade or business. In so holding, the Court brushed aside an earlier definition of "business" as "a very comprehensive term [that] embraces everything about which a person can be employed."²⁹

The *Higgins* decision was a watershed and an unfortunate one. The result violated rudimentary normative tax principles by denying deductions for ordinary and necessary expenses of earning income subject to tax. The decision seems particularly anomalous

²⁶See, e.g., *Primuth v. Commissioner*, 54 T.C. 375 (1970); *Noland v. Commissioner*, 269 F.2d 108 (4th Cir.), *cert. denied*, 361 U.S. 885 (1959); and other cases cited in 2 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶20.1.2, n. 15 (2d ed. 1990).

²⁷312 U.S. 714 (1941).

²⁸*Id.* at 715. Significantly, the Commissioner conceded that Mr. Higgins' rental real estate activity was a business and allowed deductions for those expenses fairly allocable to real estate management.

²⁹*Flint v. Stone Tracy*, 220 U.S. 107, 171 (1911) which, looking to the Bouvier Dictionary, defined "business" broadly for purposes of determining whether a corporation engaged principally in the holding and management of real estate was subject to a provision in the Corporation Tax Law of 1909 that taxed

when one considers that Mr. Higgins was permitted to deduct losses on the sale of his securities and all the expenses of his mostly passive rental real estate activity. Recognizing that the income tax was intended to tax net rather than gross income, Congress quickly responded by enacting the statutory predecessor of § 212, which allows individual taxpayers to deduct ordinary and necessary expenses incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. Thus, with exceptions and some important nuances to be noted below,³⁰ the prompt enactment of § 212 made line drawing unnecessary for purposes of determining if individual taxpayers (as well as estates and trusts) were allowed to deduct the ordinary and necessary expenses of an income-producing activity.³¹

Despite the enactment of § 212, the distinction between business and investment persisted for purposes of more specialized deductions. For example, when it enacted the predecessor of § 212 in 1942, Congress also acted to limit the ordinary loss deduction for worthless debts (now found in § 166) to debts incurred in the taxpayer's trade or business and provided that nonbusiness bad debts were to be deducted as short-term capital losses.

The purpose of § 166(d) was to limit deductions when bona fide loans to relatives and friends became worthless, but it extends to investment-related loans, and the Supreme Court has said that its purpose is "to put nonbusiness investments in the form of loans on a

corporations engaged in business.

³⁰See *infra* notes 38-40 and accompanying text.

³¹Similarly, § 167 allows depreciation deductions for property used in a trade or business or held for the production of income, and § 165 permits individual taxpayers to deduct losses incurred in a trade or business or in any transaction entered into for profit even though not connected with a trade or business.

footing with other nonbusiness investments."³²

In *Whipple v. Commissioner*,³³ the Court was required to interpret "trade or business" as used in § 166 in determining whether a taxpayer who made cash advances to several controlled corporations for which he performed services could take a business bad debt deduction when the loans became worthless. After surveying the prior case law and the legislative history, the Court concluded:

Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.

The Court went on to conclude that if full-time service to one corporation does not amount to a trade or business, performing the same service to many corporations also would not suffice. The point -- a good one given the distinction between capital and ordinary losses -- was that Mr. Whipple's loans were made to increase his investment returns, requiring his losses to be characterized as capital for tax purposes.

³²*Putnam v. Commissioner*, 352 U.S. 82 (1956). As Professors Bittker and Eustice have observed, if this was the purpose of § 166(d) Congress neglected to articulate it, and complete parity was not achieved because worthless nonbusiness bad debts are treated as a short-term capital loss while worthless securities usually give rise to a long-term capital loss. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.22[4], n. 238 (7th ed. 2000).

³³373 U.S. 193 (1963).

In *Snow v. Commissioner*,³⁴ the Court interpreted "trade or business" as the term is used in § 174(a), which then (and now) allows a taxpayer an election to currently deduct rather than capitalize "research or experimental expenditures" paid or incurred "in connection with his trade or business . . ." At its core, § 174 is a timing provision that carves out an exception to the rule that capital expenditures are not currently deductible. It was enacted to eliminate uncertainty about whether and when R & D expenses could be deducted, especially by small and growing businesses that might not yet be selling a product. The taxpayer, a limited partner in a partnership formed to develop a special-purpose incinerator, deducted his distributive share of the partnership's net operating loss in a year in which the partnership had no product for sale and was still in the development stage. The Service disallowed the deduction on the ground that the partnership was not yet carrying on a trade or business. Relying on the legislative history, the Court interpreted the language "in connection with his trade or business" in § 174(a) to be broader than the § 162(a) concept of "carrying on" a trade or business. It proceeded to allow the deduction even though the partnership was not yet carrying on an active trade or business within the meaning of § 162.

The Supreme Court's most recent definitional foray was in *Commissioner v. Groetzinger*³⁵, where the issue was whether a full-time (60 to 80 hours a week) gambler with no other profession or employment was engaged in a "trade or business" for purposes

³⁴416 U.S. 500 (1974).

³⁵480 U.S. 23 (1987).

of determining his eligibility to deduct gambling losses under a now repealed version of the alternative minimum tax. Although the gambler's losses were deductible against gambling winnings under the regular tax, the Commissioner asserted that the losses were items of tax preference under the minimum tax because the taxpayer's gambling activity was not a trade or business. After noting the lack of a general definition and surveying the case law, Justice Blackmun's opinion for the Court summed up its conclusions on the meaning of "trade or business":³⁶

. . . we conclude (1) to be sure, the statutory words are broad and comprehensive . . . ; (2) that, however, expenses incident to caring for one's own investments, even though that endeavor is full-time, are not deductible as paid or incurred in carrying on a trade or business . . . ; (3) that the opposite conclusion may follow for an active trader . . . ; (4) that Justice Frankfurter's attempted gloss upon the decision in *DuPont* was not adopted by the Court in that case; (5) that the Court indeed later characterized it as an "adumbration"; and (6) that the Frankfurter observation [in *Du Pont*] never has been accepted as law by a majority opinion of the Court, and more than once has been totally ignored.

Applying what it viewed to be "basic concepts of fairness," the Court went on to hold that active gambling was as much a trade or business as any other readily accepted activity. The significance of *Groetzinger* lies in the Court's rejection of any definition requiring business taxpayers to hold themselves out to others as engaged in the sale of goods or services -- i.e., it discards the "Frankfurter gloss" in *du Pont*. Instead, the Court concluded that an activity is a trade or business if it is "pursued full time, in good faith, and with regularity [for] the production of income for a livelihood, and is not a mere hobby."³⁷ The

³⁶*Id.* at 31-32.

³⁷*Id.* at 35.

"for a livelihood" language presumably continues to exclude the activities of passive investors from trade or business status.

2. Importance of the Distinction Between Trade or Business and Investment

Whether or not the distinction between a trade or business and investment activity is important under general tax principles depends on the type of taxpayer (e.g., individual vs. corporation) and the context in which the issue arises. Some illustrations follow.

a. *Ordinary and Necessary Expenses.* As already noted, subject to the overriding principle that capital expenditures may not be currently deducted, individual taxpayers may deduct their ordinary and necessary business expenses under § 162 and their comparable investment expenses under § 212. In the hierarchy of individual deductions, however, § 162 expenses of self-employed taxpayers and either § 162 or § 212 expenses attributable to activities that generate rents or royalties enjoy favored status because they are "adjustments to income" that may be deducted in all events above the adjusted gross income line.³⁸ Individual taxpayers may deduct § 212 investment expenses (other than those related to rents and royalties) only if they itemize deductions.

Most investment expenses also fall into the disfavored category of miscellaneous itemized deductions, which in the aggregate are deductible only to the extent they exceed 2% of the taxpayer's adjusted gross income.³⁹ The 2% limit in § 67 and the complete

³⁸I.R.C. § 62(a).

³⁹I.R.C. § 67(a). Under the alternative minimum tax, miscellaneous itemized deductions are simply not deductible. I.R.C. § 56(b)(1)(A). In addition, § 68 reduces most itemized deductions by the lesser of 3% of the excess of adjusted gross income over an indexed "applicable amount" (\$128,950 in 2000), or 80% of the

disallowance of miscellaneous itemized deductions under the alternative minimum tax have a punitive effect on taxpayers who incur legitimate expenses attributable to investments in securities, such as investment advisory and custodian fees. The policy underlying these departures from a proper normative tax base is tenuous, and the cynical view is that they were a stealth tax rate increase. Congress justified the § 67 limit on the grounds of simplification (fewer taxpayers would need to keep track of itemized deductions; § 212 deductions were typically small but presented administrative and enforcement problems for the Service) and tax reform (many § 212 deductions as well as unreimbursed employee business expenses were quasi-personal and the § 67 floor served as a crude disallowance mechanism for smaller amounts).⁴⁰ Congress has never offered a coherent explanation for the complete disallowance of miscellaneous itemized deductions under the alternative minimum tax, but presumably it had similar concerns about whether many of those deductions were personal in nature.

The preceding discussion primarily affects securities investors. Leaving aside for the moment the impact of the § 469 passive loss limitations, individuals owning rental real estate properties are generally indifferent to the distinction between business and investment. Their expenses, including depreciation, are above-the-line deductions whether allowable under § 162 or § 212, and their gains on sale are characterized as capital gain (with a higher rate for gain attributable to prior depreciation deductions). The distinction between business and investment expenses also is generally irrelevant for C

otherwise allowable itemized deductions.

⁴⁰See STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 78-79 (1987).

corporations, which may deduct all their ordinary and necessary expenses under § 162 on the sensible theory that the "trade or business" concept for a corporation encompasses any activity for profit including the management of passive investments.⁴¹ Pass-through tax entities, such as partnerships, limited liability companies and S corporations, generally characterize their expenses at the entity level and retain that character as they flow through to the partners or shareholders.⁴² For this purpose, the narrower concept of trade or business applies rather than the very broad approach adopted in the corporate context.

b. *Traders v. Investors.* From the preceding discussion, it would appear that a securities investor can never be in a trade or business for any purpose under the tax law. The courts, however, have distinguished between "traders," who are considered to be engaged in a trade or business (for some purposes but not others), and "investors," who are merely engaged in an income-producing activity that falls short of a trade or business. The stakes can be significant. Although individual traders (because they are not dealers) normally recognize capital gains and losses on their securities transactions, they may deduct the ordinary and necessary expenses of their trading activity on Schedule C, above the adjusted gross income line under § 162, rather than below the AGI line (or not at all) under § 212. Trader status also may open the door to business bad debt deductions, a home office deduction, and the ability to deduct margin interest expense under § 163 as an adjustment to income rather than as an itemized deduction.⁴³

In a major case on this point, the Court of Claims defined a trader as one whose

⁴¹See generally BITTKER & EUSTICE, *supra* note 32, ¶ 5.03, n. 27.

⁴²See generally WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF

profits are derived from the "direct management of purchasing and selling."⁴⁴ The Ninth Circuit has drawn a similar distinction between investors and traders:⁴⁵

In the former [investment], securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis.

Traders have a short time horizon, and the bulk of their income is derived from gains on sale rather than interest or dividends. Although "trading" need not be a trader's only trade or business (a trader could also be a member of Congress, for example, or serve as First Lady), trader status is determined by the taxpayer's intent, the nature of the income derived from the activity, and the frequency, extent and regularity of the taxpayer's securities transactions.⁴⁶

The trader vs. investor issue can be particularly relevant for individual partners of limited partnerships engaged in sophisticated investment strategies, such as risk or event arbitrage and certain hedging techniques. If the partnership is merely "investing," it will pass through its ordinary and necessary expenses (e.g., management fees, rent and the like) as "expenses related to portfolio income" which are deductible at the partner level under § 212 and thus subject to the 2% limit under § 67 for purposes of the regular tax and not

PARTNERSHIPS AND PARTNERS ¶ 9.02[3][k] (3d ed. 1996).

⁴³I.R.C. §§ 166(a); 280A(c); 163(d).

⁴⁴Levin v. United States, 597 F.2d 760, 765 (Ct. Cl. 1979).

⁴⁵Purvis v. Commissioner, 530 F.2d 1332, 1334 (9th Cir. 1976), *quoting* Liang v. Commissioner, 23 T.C. 1040, 1043 (1955).

⁴⁶See Purvis v. Commissioner, *supra* note 45; Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983).

deductible at all under the alternative minimum tax. Trading partnerships, however, take the position that their expenses are deductible under § 162 and net them against dividends, interest and other forms of ordinary trading income before passing through a single net amount that will show up as "nonpassive income" on Line 1 of the partner's Form K-1. For either investors or traders, however, gains on sale of securities will be capital rather than ordinary (although traders are likely to generate more short-term gains), and interest expense will be subject to the investment interest limitations of § 163(d).⁴⁷ As discussed briefly below,⁴⁸ both trading and investing income also will be nonpassive for purposes of the § 469 passive loss limitations and thus cannot be sheltered by passive losses from other sources (e.g., a real estate or natural resources partnership investment).

The trader vs. investor distinction also may be significant for foreign investors, who must file returns and pay U.S. federal income tax with respect to income effectively connected with the conduct of a trade or business within the United States.⁴⁹ Trading in stocks, securities or commodities for a foreign investor's own account (including through a partnership) is excluded from the definition of "trade or business within the United States,"⁵⁰ whether or not the principal office of the activity is outside the United States.⁵¹

⁴⁷See *infra* notes 61-65 and accompanying text for further discussion of the § 163(d) investment interest limitation, which applies to noncorporate taxpayers.

⁴⁸See *infra* note 60 and accompanying text.

⁴⁹See I.R.C. §§ 871-879.

⁵⁰I.R.C. § 864(b)(2)

⁵¹Prior to 1997, a non-U.S. partner of a partnership that traded in stock, securities or commodities *was* considered to be engaged in a U.S. trade or business unless the partnership's principal office *was not* in the United States. Location was determined by whether "all or a substantial portion" of ten largely ministerial activities specified in regulations (and known popularly as The Ten Commandments) were carried on at or

To sum up, if it offers some advantage, an individual taxpayer or pass-through entity may successfully claim to be in the trade or business of buying and selling securities and related financial products, but only if the taxpayer (or the partnership in which he is an investor) personally manages the activity and trades with sufficient frequency.

c. *Gains from Dealings in Property.* The character of gain or loss realized on a sale or exchange of property may or may not turn on whether the property was used in a trade or business. Gains and losses on the disposition of dealer property, such as inventory and other property held primarily for sale to customers in the ordinary course of a taxpayer's trade or business, are characterized as ordinary rather than capital.⁵² Preferential capital gains rates (and limitations on current deductibility of net capital losses) generally apply to dispositions of capital assets, a category that, while defined by exclusion, winds up including virtually all classic forms of investment property (e.g., stocks, bonds and collectibles) but excludes real and depreciable property used in the taxpayer's trade or business. The distinction is more illusory than real, however, because the gain attributable to asset appreciation⁵³ on most non-dealer trade or business property held for more than one year ultimately is characterized as capital gain by § 1231, at least if the taxpayer's net

from an office or offices located outside the United States. See Treas. Reg. § 1.864-2(c)(ii) & (iii) (applicable to tax years beginning on or before December 31, 1997). The Revenue Act of 1997 repealed The Ten Commandments.

⁵²I.R.C. § 1221(a)(1).

⁵³Gain attributable to prior depreciation deductions that reduced the taxpayer's basis in depreciable personal property (e.g., equipment) is recaptured and characterized as ordinary income under § 1245. The § 1245 recapture regime applies to depreciable property used in a trade or business or held for the production of income (i.e., for investment). Gain attributable to depreciation on real property remains as capital gain but, if the property has been held for more than one year, the maximum rate is 25% (rather than the 20% rate generally applicable to other capital assets). I.R.C. § 1(h).

gains from § 1231 transactions for the taxable year exceed the net losses.⁵⁴ If a taxpayer's § 1231 losses exceed gains, the losses are ordinary and, as such, they may be deducted against ordinary income without regard to the usual \$3,000 per year limitation.⁵⁵ This "heads I win, tails you lose" netting regime on the loss side sometimes motivates taxpayers to argue (with mixed success) that a single piece of rental real estate requiring little or no active management is nonetheless used in the taxpayer's rental trade or business.⁵⁶ The agenda, if the property is sold at a loss and the § 1231 arithmetic is favorable (i.e., losses exceeds gains), is to escape the limitations on capital losses.

d. *Anti-Avoidance Provisions.* The Internal Revenue Code includes numerous provisions designed to prevent noncorporate taxpayers from deducting losses from certain "tax shelter" activities against income from other sources. These anti-avoidance rules often distinguish between business and investment. Legitimate deductions and losses from business activities are generally allowed without limitation when the taxpayer is actively involved, while gratification may be delayed for some types of investment losses that exceed the income generated from the activity.

The principal weapon to prevent tax shelters is § 469, which acts to defer deductions of net losses from a "passive activity" against nonpassive income. "Passive" and

⁵⁴I.R.C. § 1231(a).

⁵⁵I.R.C. § 1231 (a)(2). *See* I.R.C. § 1211(b).

⁵⁶*See, e.g.,* Grier v. United States, 218 F.2d 603 (2d Cir. 1955) (rental of a single dwelling unit on long-term lease to single tenant was not a trade or business where taxpayer's efforts were minimal and no employees were required); Wasnok v. Commissioner, 30 T.C.M. 39 (1971) (rental of single home previously used by taxpayers as residence to various tenants was a trade or business); Hazard v. Commissioner, 7 T.C. 372 (1946), acq. 1946-2 C.B. 3.

"nonpassive" have special meanings under § 469 that do not equate with the classic use of those terms. For § 469 purposes, a "passive activity" is not limited to investing for one's own account. Rather, it is any activity which involves the conduct of any trade or business and in which the taxpayer does not materially participate.⁵⁷ With several exceptions that need not be discussed here, the term "passive activity" includes any rental activity (whether or not it is a trade or business or the taxpayer materially participates),⁵⁸ and a "trade or business" includes any activity with respect to which expenses are allowable as a deduction under § 212.⁵⁹ In applying the passive loss limitations, most of the items that we normally would consider to be "passive" are carved out and placed in the narrower category known as "portfolio" income. Specifically, interest, dividends, annuities, royalties not derived in the ordinary course of business, and gains or losses attributable to the disposition of these types of portfolio-producing property or other property "held for investment" are not treated as income from a passive activity.⁶⁰ The objective is to prevent high-income individuals from deducting losses from passive investments (e.g., limited partnerships and some direct rental real estate activities) against their compensation, other business income, dividends, interest and capital gains.

⁵⁷I.R.C. § 469(a)(1).

⁵⁸I.R.C. § 469(c)(2)

⁵⁹I.R.C. § 469(c)(6).

⁶⁰I.R.C. § 469(e)(1). The regulations place securities "traders" in a special category by providing that the activity of trading personal property for the account of the owner is not a passive activity without regard to whether it is a trade or business. Treas. Reg. § 1.469-1T(e)(6). A specific target of the regulations were limited partnerships whose "investment" activities may be so extensive that they rise to the level of a "trade or business," causing their "portfolio"-type income (e.g., interest, dividends, capital gains) to be characterized as "passive" under § 469. If this were allowed, such partnerships could serve as passive income generators (PIGs) and facilitate the very tax shelters (e.g., through the deduction of passive losses) that Congress sought to eliminate when it enacted § 469.

Similarly, unless the passive loss limitations apply, noncorporate taxpayers may deduct interest expense connected to a trade or business activity without limitation.⁶¹ They may deduct "investment interest," however, only the extent of net investment income for the taxable year, with any disallowed excess being available as a carryover.⁶² "Investment interest" is interest paid or accrued on indebtedness properly allocable to "property held for investment."⁶³ "Property held for investment" primarily consists of property that produces various types of portfolio-type income, such as dividends, interest, annuities, or royalties not derived in the ordinary course of a trade or business.⁶⁴ It also includes any property interest held by a taxpayer in an activity that involves the conduct of a trade or business which is not a "passive activity" and with respect to which the taxpayer does not "materially participate."⁶⁵

e. *U.S. Taxation of Foreign Persons and Income.* For those restless readers who have not yet abandoned this section of the paper, the U.S. international tax regime offers a final opportunity to examine the distinction between business and investment activities in a context where it clearly matters. This far from exhaustive discussion focuses on basic inbound transactions (U.S. income taxation of nonresident aliens and foreign corporations) and only touches upon the Code's outbound (U.S. income taxation of foreign business and investment activities by U.S. persons) regime.⁶⁶

⁶¹*Cf.* I.R.C. § 163(h)(2)(A).

⁶²I.R.C. § 163(d)(1), (2).

⁶³I.R.C. § 163(d)(3)(A).

⁶⁴I.R.C. § 163(d)(5)(A)(i).

⁶⁵I.R.C. § 163(d)(5)(A)(ii).

⁶⁶For good general discussions of U.S. international taxation, *see* JOSEPH ISENBERGH, INTERNATIONAL TAXATION (2000); PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL

The business v. investment distinction is critical to the U.S. tax treatment of inbound transactions. U.S. resident aliens, like U.S. citizens, are taxable on their worldwide income. Nonresident aliens are fully taxable on all income that is (or is treated as) effectively connected with the conduct of a U.S. trade or business.⁶⁷ A flat rate tax of 30 percent is imposed on certain types of fixed or determinable annual or periodic U.S. source "non-business" income -- largely passive investment income, such as dividends, interest (including original issue discount), and royalties.⁶⁸ Capital gains from the sale of U.S. investment assets (other than real estate) and certain forms of interest income, however, are exempt from tax,⁶⁹ and tax treaties may modify these rules, such as by lowering the withholding rate on dividends. Professor Paul McDaniel and Hugh Ault have crisply described the theory underlying all these rules:⁷⁰

A foreign taxpayer who is engaged in a US trade or business has achieved a substantial level of economic penetration in the US. He is not merely a passive investor but has become a direct participant in the economic life of the country.

The determination of whether an activity rises to the level of a "trade or business" is sometimes based on specific statutory provisions and otherwise turns on the facts and circumstances of each case. For example, as noted earlier, the Code excludes from trade or business status most trading in stocks, securities or commodities for a foreign investor's own account, even if the foreign investor maintains a U.S. office that is the investor's

TAXATION (4th ed. 1998).

⁶⁷I.R.C. § 871(b).

⁶⁸I.R.C. § 871(a).

⁶⁹I.R.C. § 871(a)(2).

⁷⁰MCDANIEL & AULT, *supra* note 66, at 49.

principal place of business.⁷¹ But it also expressly provides that the performance of personal services is a trade or business,⁷² and it deems gains and losses from sales of U.S. real property interests by foreign persons to be income from an effectively connected U.S. trade or business.⁷³

As for the case law, the factors employed by the courts are quite similar to those used in the purely domestic setting. At the core of the line drawing is the active v. passive or portfolio distinction. A trade or business requires a certain level of entrepreneurial activity while investment connotes a commitment of capital coupled with the modern equivalent of coupon clipping and includes holding property for appreciation in value. Rental real estate, as in other contexts, is a hybrid category, and the case law leaves one searching for bright line rules. This much seems clear. If an owner actively manages the property without the use of agents, the activity is a trade or business. But if all management decisions are delegated to agents and the property is subject to a triple net lease, the activity is a mere passive investment.

Turning to the business vs. investment distinction in the context of outbound transactions, the ability to provide accessible generalizations becomes difficult if not impossible without meandering into arcane backwaters that are best left to the foreign tax cognoscenti. But since some well accepted UBIT avoidance strategies involve offshore structures, a brief but necessarily superficial overview of the tax treatment of foreign business and investment activities by U.S. persons may be useful to lay a foundation for

⁷¹I.R.C. § 864(b)(2).

⁷²I.R.C. § 864(b)(1).

things to come.

The principal concern of the Code's outbound tax regime is to regulate the extent to which U.S. taxpayers can defer or avoid U.S. tax on their foreign business and investment activities, especially when those activities are conducted in jurisdictions with little or no tax. Subpart F, for example, patrols controlled foreign corporations (CFCs), which are foreign corporations in which more than 50% of the stock (measured by voting power or value) is owned by U.S. persons owning 10% or more of the voting stock.⁷⁴ Subpart F requires 10-percent-or-more U.S. shareholders to include in income their pro rata share of certain categories of the CFC's income even before it is repatriated.⁷⁵ Although much of this targeted Subpart F income emanates from trade or business activities conducted by the CFC, it also includes "foreign personal holding company income," which principally consists of dividends, interest, rents, royalties, capital gains, and gains from currency and commodity transactions.⁷⁶

The Code also contains provisions aimed at foreign investment activities of U.S. persons. Once again, the broad goals are to prevent avoidance or deferral of U.S. tax on investment income through offshore vehicles. The provisions are complex and overlapping and justifiably have been described as "Medussa-like."⁷⁷ Closely held "incorporated pocketbooks" may be subject to the foreign personal holding company rules, which generally require U.S. shareholders of closely held foreign corporations with

⁷³I.R.C. § 897(a).

⁷⁴I.R.C. §§ 951-964.

⁷⁵I.R.C. § 951(a).

⁷⁶I.R.C. §§ 952(a); 954(a)(1), (c).

⁷⁷BITTKER & EUSTICE, *supra* note 32, ¶ 15.40[3].

significant passive investment income to be taxed directly on the corporation's undistributed income.⁷⁸ The passive foreign investment company ("PFIC") rules are directed at U.S. shareholders of widely held offshore investment vehicles, such as foreign mutual funds.⁷⁹ Very generally, they require U.S. shareholders to pay a form of interest charge for any deferral benefit at the time the PFIC stock is sold or when substantial distributions are received.⁸⁰ Alternatively, shareholders who make a qualified electing fund election are taxed currently on the corporation's undistributed income, subject to an election to defer payment of the tax plus an interest charge until a disposition occurs or a distribution is received.⁸¹

3. Summary and Conclusions

The line between trade or business and investment under general tax principles and for specialized regimes is less of a clear boundary than it is a spectrum. Statutory provisions that make the distinction are interpreted based on their underlying policy, and the resolution of specific controversies is often driven by the facts and circumstances.

At one end of the spectrum, the purest form of trade or business is an active and profit-seeking entrepreneurial activity that requires the taxpayer to devote considerable time and effort. A trade or business does not require the sale of goods or services to

⁷⁸I.R.C. §§ 551-558. If a U.S. shareholder would be taxable on a foreign corporation's income under both Subpart F and the foreign personal holding company rules, Subpart F takes precedence. I.R.C. § 951(d).

⁷⁹I.R.C. §§ 1291-1298. A PFIC generally is a foreign corporation with at least 75% of its income consisting of passive investment income, or at least 50% of its assets held for the production of income. I.R.C. § 1297(a)(1), (2).

⁸⁰I.R.C. § 1291.

⁸¹I.R.C. §§ 1293-1295.

customers and thus includes the activities of employees and full-time gamblers. At the other end, a purely passive investment activity entails a commitment of capital, a time horizon extending well beyond day trading, and a coupon clipping lifestyle -- i.e., the collection of a periodic stream of income from the taxpayer's capital as well as the realization of gains and losses on sales of assets held for the production of income.

The presumption of the statutory and case law is that investing in securities and similar financial assets for one's own account is investment, however extensive the activity. The ramifications of this characterization for individual taxpayers is that their deductions for investment expenses, losses, bad debts, and some other items are or may be limited for various reasons, but their gains on disposition of investment assets will be tax favored.

Under general tax principles, commercial and residential rental real estate activities usually fall at various points along the trade or business side of the spectrum and only rarely are treated as passive investment activities except when necessary to prevent abusive tax sheltering. Trade or business status is assured for most purposes if the taxpayer actively manages the property, either directly or through agents, but it also may be achieved if minimal time and effort is required to keep the tenants happy and collect the rent. The anomaly which first surfaced in *Higgins v. Commissioner* thus persists. Indeed, one can envision a situation where a taxpayer's securities investing activity requires far more individual time and effort than a long-term net lease of commercial property to a single stable tenant for a steady stream of rental income unrelated to the tenant's profits.

In the last analysis, the preceding discussion does not offer much illumination on the contours of the UBIT. Calls for uniform definitions of "trade or business" or

"investment" throughout the Code are unachievable because of the numerous and disparate contexts in which the concepts are employed. Although attention to context and an examination of the facts of each case is untidy and will disappoint the plain meaning militia, it is the reality because lines drawn for one tax regime are not necessarily transferable. As Justice Blackmun observed in *Groetzinger*, "an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code."⁸²

III. TAXING TRADITIONAL AND NONTRADITIONAL CHARITABLE INVESTMENTS UNDER THE UBIT

A. Introduction

When one moves from general tax principles to the taxation of nonprofit organizations, the line between a trade or business and investment is often critical. An otherwise exempt organization's income from a trade or business is taxable if the activity is regularly carried on and not substantially related to the organization's exempt purposes, but most income from passive investment activities is excluded. Before turning to the line drawing and other (largely technical) UBIT issues, however, one needs to understand how nonprofits are deploying their capital, and how institutional investment behavior has changed from its traditional bias favoring Triple A corporate bonds, blue chip stocks, and uncomplicated rental real estate.

This Part begins with an aerial view of the contemporary nonprofit investment

⁸²480 U.S. at 36.

landscape, apart from taxes.⁸³ At first glance, it appears that we are dealing primarily with the wealthiest and most entrepreneurial residents of the sector -- universities, private and community foundations, mainstream religious groups, and well-endowed research institutes, art museums and the like.⁸⁴ These organizations are better able to diversify their portfolios and have entree to the wide range of nontraditional financial products and strategies employed by institutional investors. Some universities, such as Harvard, Stanford, Princeton, Texas and Duke, have established separate management companies with well compensated staffs to manage part of their endowments in-house and oversee a diverse group of outside advisors.⁸⁵ Even institutions with smaller endowments can diversify by investing in hedge funds and other commingled vehicles or through "fund of fund" pools assembled by The Common Fund⁸⁶ (for educational institutions) and The Investment Fund for Foundations⁸⁷ (primarily for private foundations but also available to

⁸³Some of this history is derived from ROBERT F. FRY, JR., *NONPROFIT INVESTMENT POLICIES* (1998), and BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE* (1996). *See also* BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (1996 ed.) and DAVID F. SWENSEN, *PIONEERING PORTFOLIO MANAGEMENT* (2000).

⁸⁴Although they are not the focus of this paper, many of the UBIT issues discussed here also affect tax-exempt pension trusts.

⁸⁵*See* Pietrina Scaraglino & Kathy L. Schulz, *Investment of Endowment: A Primer*, 27 N.Y.U. CONF. ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS ¶ 5.03[1] (1999); Jonathan N. Axelrod & Stephen E. Fran, *One Money Manager's Pay is in Ivy League of Its Own*, WALL ST. J., July 25, 1996, at C1.

⁸⁶The Common Fund, established in the 1970's, manages approximately \$ 17 billion in endowment funds from over 1,300 colleges and universities. It maintains numerous separate pooled investment funds and delegates the management to nearly 100 outside advisers. *See* The Common Fund, *Principles of Endowment Management*, available at <<http://www.commonfund.org>>. The Common Fund enjoys its own customized tax-exempt status under § 501(f) and various tax and securities law exemptions.

⁸⁷The Investment Fund for Foundations ("TIFF"), a relative newcomer that commenced operations in 1994, began by offering a family of no-load mutual funds in various asset classes. It has expanded to operate pools for absolute return, private equity, and real estate investments. TIFF exclusively uses outside managers and offers access and economies of scale to small and moderate sized foundations seeking to diversify their investments. As of June 30, 2000, TIFF had \$1.1 billion under management in its mutual funds, \$185 million in its absolute return pool, and almost \$400 million in its private investment program. THE INVESTMENT FUND FOR FOUNDATIONS, *Commentary*, June 30, 2000. TIFF is operated as a not-for-profit

§ 501(c)(3) public charities not eligible for The Common Fund).

Nonprofit organizations also are increasingly conducting entrepreneurial activities through joint ventures or wholly owned subsidiaries. Some organizations exploit their unique intangible capital (mailing lists, logos, athletic programs, research, art collections) through licensing or sponsorship arrangements that require little effort but yield healthy returns. Four recently publicized examples, all involving respected elders of the nonprofit sector, illustrate the blurring line between active business and passive investment:

- The National Geographic Society acquired 30% of iExplore, Inc., a privately held Internet company that sells adventure and experiential vacation tours in 152 countries. The 112-year old Society reportedly will incorporate iExplore's data base into its own website and give iExplore marketing access to its membership. Securities analysts say that the National Geographic's endorsement is "like the Good Housekeeping seal of approval" and would give iExplore an edge over its competitors.⁸⁸
- Columbia University has joined forces with NutritionU.com, an online information company, and UNext.com, a start-up backed by former junk-bond impresario Michael Milken, to offer Internet courses created by prestigious universities. Columbia also has created Fathom.com, a joint venture with other institutions including the New York Public Library, the

cooperative, and its mutual funds and other investment pools are subject to the usual SEC regulations. Several times during the 1990's, Congress approved legislation conferring on foundation investment cooperatives the same tax and securities law exemptions enjoyed by The Common Fund, but each time the bill fell victim to political gridlock.

⁸⁸Jane Levere, *National Geographic Buys Stake in iExplore*, N.Y. TIMES, Aug. 21, 2000, at C7.

British Library, and the Smithsonian Institution, to offer online education.⁸⁹

- The College Board, which administers the SAT college entrance test, has created a for-profit subsidiary to operate a Web site to offer tutoring and other information services to college applicants. The site initially will be financed in part by advertising and commercial links to sellers of cars, computers, credit cards, and dorm furniture.⁹⁰
- The Museum of Modern Art in New York has announced that it will operate a for-profit Web site with London's Tate Gallery, selling exclusive products from coffee cups to furniture. The site also will provide extensive information about art throughout the world.⁹¹

The movement toward nontraditional investments and other entrepreneurial activity has forced the Service and tax advisors to grapple with issues that were not contemplated when the UBIT was enacted. When UBIT problems do arise, however, they often can be avoided with proper planning, albeit with structures that seem needlessly cumbersome and inefficient in light of the stated policy favoring exemption for investment income. Indeed, although a few aspects of the UBIT can be nettlesome or intriguing, particularly to tax lawyers, it appears that investment officers for the very largest endowments are not all that concerned about taxes because in practice the UBIT is not a

⁸⁹Karen W. Arenson, *Columbia Leads Academic Pack in Turning Profit From Research*, N.Y. TIMES, Aug. 2, 2000, at A25.

⁹⁰Jodi Wilgoren, *Aged Upstart, College Board Is Joining Gold Rush on Web*, N.Y. TIMES, Sept. 25, 1999, at A1.

⁹¹Daniel Costello, *Museum of Modern Art's Ambitious Expansion Plan Faces Trouble*, WALL ST. J., June 7, 2000, at B1; David Rockefeller, *Letter to Editor*, WALL ST. J., June 15, 2000, at A27.

problem or easy to avoid.⁹² This attitude of indifference is captured by an observation made to the author by the manager of a large endowment when asked whether the university paid any UBIT. The response (more or less) was: "No, I don't think so, not much if anything on what we do, although I think they may have some problem over at the driving range at the golf course."

Statistics confirm the suspicion that the UBIT is a voluntary tax, particularly for charities. Although reported taxable profits from unrelated activities are on the rise,⁹³ more than half of the estimated 40,621 organizations filing UBIT returns in 1996 reported a zero taxable income or a deficit.⁹⁴ And more than half the total UBIT tax liability of \$372.6 million in 1996 was paid by pension trusts and § 501(c)(9) voluntary employee beneficiary associations.⁹⁵ Although § 501(c)(3) organizations accounted for about 25% of total returns filed, the collective bottom line of (c)(3)'s showed almost a \$1 million deficit, and (c)(3)'s as a group paid only \$93.8 million of UBIT in 1996 -- about 25% of total income tax paid by all UBIT filers, including pension trusts.⁹⁶

⁹²The author came to this conclusion independently but notes that it was among the themes of a November 1999 conference at the Hauser Center for Nonprofit Organizations at Harvard where the topic was: "The Unrelated Business Income Tax: The Dog That Doesn't Bite." The panelists there, several of whom will be presenters and commentators at this conference, apparently concluded that the UBIT has in effect become a voluntary tax. This brings to mind Professor A. James Casner's celebrated comment in 1976 characterizing the federal wealth transfer taxes: "In fact, we haven't got an estate tax, what we have, you pay an estate tax if you want to; if you don't want to, you don't have to." GEORGE COOPER, A VOLUNTARY TAX? 1 (Brookings Institution 1979), *quoting from Estate and Gift Taxes: Hearings Before the House Ways and Means Comm.*, 94th Cong., 2d Sess., pt. 2, 1335 (1976) (statement of Prof. A. James Casner). So it seems to be with the UBIT.

⁹³For the tax year 1996, net taxable profit from unrelated business activities increased 31% from 1995, following an 82% increase from 1994 to 1995. Margaret Riley, *Unrelated Business Income of Nonprofit Organizations, 1996*, IRS STATISTICS OF INCOME BULLETIN 123 (IR-2000-43) (Spring 2000).

⁹⁴*Id.* at 127.

⁹⁵*Id.* at 138.

⁹⁶*Id.* Some of these statistics may be misleading because they do not include taxable subsidiaries.

B. The Modern Nonprofit Investment Landscape

1. The Legal Environment

Until fairly recently, the law regulating nonprofit investing lagged well behind investment theory and practice. The sources of guidance were state laws governing private trusts, principally The Prudent Man Rule enunciated in *Harvard College v. Amory*.⁹⁷ While seemingly offering more flexibility and discretion to go beyond prescribed "court lists" of permissible investments, the Prudent Man Rule was interpreted cautiously by courts and legislatures, and it failed to adapt to new investment concepts and strategies. Among its deficiencies were: certain techniques (e.g., options, short sales, currency hedging, unproductive assets, leverage) were presumed to be imprudent; each investment in a portfolio was viewed in isolation, without reference to its role in a diversified portfolio; and investments in mutual funds or even use of passive indexing strategies were seen as improper delegations of trustee duty. The result was an ultraconservative bias in favor of fixed income investments, particularly U.S. government bonds, with some tolerance for high yielding equities. Bevis Longstreth has summed up this disconnect:⁹⁸

Widely accepted lessons of modern economics push hard against these constraining notions of prudence. Indeed, it would not be an exaggeration to observe that today the prudent man rule as elaborated in [Professor Austin Wakeman Scott's] *Treatise [on trusts]*, the Restatement

⁹⁷26 Mass. (9 Pick.) 446 (1830).

⁹⁸LONGSTRETH, *supra* note 83, at 5.

[Second of Trusts], and much of the case law would virtually compel a fiduciary to act imprudently in terms of economic reality.

The legal environment began to change beginning in the 1960's and 1970's -- a period marked by high inflation and the coming of age of influential academic studies of investment theory. A study on endowment funds commissioned by the Ford Foundation in 1969 criticized the time warped behavior of nonprofit investment managers, many of whom had experienced the 1929 crash and understandably may have been unduly preoccupied with protecting themselves against losses and liability. The authors of the Ford study, Professors William L. Cary and Craig Bright, concluded that legal restrictions imposed upon trustees were not as severe as managers of nonprofit endowments believed. Perceived impediments to investing for growth and total return, and to spending realized gains as needed, were found to be more legend than lore.⁹⁹

The Ford Foundation study proved to be the catalyst for the 1972 Uniform Management of Institutional Funds Act (UMIFA), which has been adopted in the vast majority of states. UMIFA applies to "incorporated and unincorporated organization[s] organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a governmental organization to the extent that it holds funds exclusively for any of those purposes."¹⁰⁰ Many of the principles of UMIFA have been extended to charitable trusts through the American Law Institute's Restatement (Third) of Trusts¹⁰¹ and the Uniform Prudent Investor Act. These legal developments have provided

⁹⁹See WILLIAM L. CARY & CRAIG B. BRIGHT, THE LAW AND LORE OF ENDOWMENT FUNDS 60-66 (1969).

¹⁰⁰UNIF. MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 1(1).

¹⁰¹See, e.g., RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE §§ 171, 210-213, 227-229, 379, 389 (1992).

fiduciaries with legal protection if they adopt and maintain appropriate investment policies. They also impose an affirmative duty to abandon the fixed income bias of the Prudent Man Rule and embrace the now well-accepted dictates of Modern Portfolio Theory.¹⁰²

Stripped of detail, UMIFA and the UPIA provide the following criteria for prudent investing:

- (1) The standard of prudence is applied to any single investment as part of the total portfolio rather than to individual investments; the key is whether the investment is prudent in light of the overall investment policy for the portfolio.
- (2) The trade-off in all investing between risk and return is a fiduciary's central consideration.
- (3) Trustees may invest in anything that plays an appropriate role in achieving the risk/return objectives of prudent investing; there are no per se imprudent investments.
- (4) Diversification is an essential element of prudent investing;
- (5) Delegation of investment and management functions is not only permitted, it is encouraged and may be required.
- (6) Prudence is measured at the time an investment decision is made, not on the basis of hindsight.
- (7) Endowments should be managed for "total return" -- i.e., dividends, interest

¹⁰²See *infra* notes 103-111 and accompanying text.

and capital appreciation -- and thus distributions may be made from both realized and unrealized gains, provided that such decisions take into account the effects of inflation to preserve the long-term purchasing power of the fund.

2. The Investment Environment

The legal reforms outlined above are consistent with the concept of Modern Portfolio Theory. It is not the purpose of this paper to offer a lengthy exegesis on the virtues of asset allocation, risk-reward relationships, the efficient frontier, active vs. passive investment, bottom-up vs. top-down, the beta theory of risk, and the like. It is sufficient for our purposes to summarize a few common sense principles at the heart of contemporary endowment investment philosophy:¹⁰³

- (1) Total return investing requires an understanding of the relationship of risk to return, taking into account the investor's time horizon. Or, as Burton Malkiel succinctly puts it, "[w]hen all is said and done, risk is the only variable worth a damn in the market."¹⁰⁴
- (2) The mix of investments in a portfolio -- i.e., asset allocation -- is more important than picking individual stocks and bonds.

¹⁰³For a comprehensive discussion and empirical study of modern trust investment practices in light of the evolving legal environment, see Martin D. Begleiter, *Does the Prudent Investor Need the Uniform Prudent Investor Act -- An Empirical Study of Trust Investment Practices*, 51 ME. L. REV. 27 (1999).

¹⁰⁴MALKIEL, *supra* note 83, at 227.

- (3) Diversification is essential to minimize risk and increase return. Prudent institutional portfolio management requires diversification beyond traditional asset classes, such as domestic stocks and bonds, and into nontraditional high-return asset classes that historically may not be highly correlated with the U.S. equity markets.

The acceptance of Modern Portfolio Theory, along with the favorable legal developments already discussed, have fueled a movement to nontraditional investments by nonprofit endowments.¹⁰⁵ One of the best articulations of the modern philosophy is found in Yale's 1995 investment report, an authoritative and highly readable primer for nonprofit institutional investors:¹⁰⁶

Investing with an equity bias is the first tenet of Yale's investment philosophy. The goals of providing substantial resources to the operating budget and maintaining purchasing power of Endowment funds require investment in assets with high expected returns, principally equities, broadly defined. Returns from fixed income investments historically have been inadequate to support current needs and compensate for inflation. Unfortunately, higher expected returns from equities are accompanied by higher expected risks, with the potential for fluctuating endowment values and spending levels.

This philosophy has influenced Yale, other large university endowments, and many large private foundations to combine quantitative analysis and market judgment to structure a portfolio that goes well beyond stocks and bonds.¹⁰⁷ According to its 1998-99 Financial

¹⁰⁵See Thomas J. Billitteri, *Hedging Their Bets: Big Foundations and Universities Turn to Non-Traditional Investments*, CHRON. OF PHILANTHROPY, Oct. 22, 1998, at 1, 33-35.

¹⁰⁶YALE UNIVERSITY, THE YALE ENDOWMENT 1995, 10 (1995).

¹⁰⁷According to the 1999 NABUCO Endowment Study, in fiscal 1999 the 509 colleges and universities participating in the study on average invested 53.7% of their portfolios in U.S. stocks, 21.6% in U.S. bonds, 10.6% in foreign stocks, 1.5% in foreign bonds, 4% in cash, and 8.6% in other investments, including various types of hedge funds, venture capital, real estate, natural resources, leveraged buyouts, and other

Report, Yale's current target asset allocation endowment policy follows a trend away from traditional domestic marketable securities and toward nontraditional asset classes. In 1989, for example, more than 70% of Yale's endowment was committed to stocks, bonds and cash, while today only 25% is allocated to domestic equity and fixed income, with 22.5% targeted for nontraditional investments such as "absolute return" (22.5%),¹⁰⁸ foreign equities, including emerging markets (10%),¹⁰⁹ private equity (25%),¹¹⁰ and real estate and related assets such as timberland (17.5%).¹¹¹ Apart from more diversified asset

private equity opportunities. 1999 NACUBO Study, *supra* note 7, at 8. The most successful institutions have been those allocating a greater percentage of their endowments to private equity. But this trend is not universal. New York University's endowment, for example, was invested primarily in high-grade bonds throughout the bull market of the 1980's and 90's, and only 12.5% was in equities as late as 1994. See Roger Lowenstein, *Intrinsic Value: How Larry Tisch and NYU Missed Bull Run*, WALL ST. J., Oct. 16, 1997, at C1. Some other endowments suffered from lack of diversification. See, e.g., John Hechinger, *Emory U. Gets a Lesson in Subtraction As Coke's Stock Fails to Make the Grade*, WALL ST. J., Jan. 28, 2000, at C1.

¹⁰⁸YALE UNIVERSITY, FINANCIAL REPORT 1998-1999, available at <www.yale.edu/fr98-99>. Yale claims to have coined the term "absolute return." Absolute return investments are supposed to provide returns largely independent of overall market swings. As explained in Yale's 1997 Endowment Update:

Absolute return managers focus on exploiting market inefficiencies. ... Event-driven strategies generally involve creating hedged positions in mispriced securities and are dependent on a specific corporate event, such as a merger or bankruptcy settlement, to achieve targeted returns. Value-driven strategies also entail hedged investments in mispriced securities, but rely on changing company fundamentals or increasing market awareness to drive prices toward fair value. Opportunistic value investments are deep value plays with generally unhedgeable market exposure; the insulation provided by substantially discounted prices (along with expected lack of correlation with traditional marketable securities) qualifies such opportunities as absolute return.

Absolute return strategies sometimes are referred to as "alternative" investments, a broader category that also embraces private equity.

¹⁰⁹Foreign equities include direct investments in portfolios of foreign companies, foreign mutual funds, and other pooled investment vehicles (usually limited partnerships), and include securities in emerging markets.

¹¹⁰Private equity investments are made in a range of markets including venture capital, leveraged buyouts, oil and gas, international private equity, and other illiquid asset plays.

¹¹¹*Id.* at 20. Real estate investments can be made directly, in a joint venture with for-profit partners, or through pooled vehicles such as limited partnerships and real estate investment trusts. Yale, for example, focuses primarily on high-quality institutional ownership positions in partnerships with specialized entrepreneurial real estate operators who exploit market inefficiencies. The Yale Endowment 1995, at 21-22. Stanford's real estate investments (16% of its strategic allocation as of August 31, 1999) includes a large

allocation, nonprofit investors increasingly engage in risk management and income enhancement strategies that were rarely if ever utilized when the UBIT was first enacted. Examples include short sales, commodities, options, derivatives, and securities lending.

Having surveyed the terrain, this Part next turns to how the UBIT draws the line between business and investment activities, beginning with an overview of its history and policy and then exploring basic principles, trouble spots, and avoidance strategies.

C. The UBIT: History and Policy (in a Nutshell)

1. The Destination of Income Test

The enactment of the unrelated business income tax marked a legislative retreat from unbridled tax exemption for nonprofit organizations. The prevailing view had been that an organization conducting a business, either directly or through a separate "feeder" subsidiary, still qualified for exemption if its profits were dedicated to charitable or other exempt purposes. The early origins of this destination of income test can be traced back to a dispute between the Insular Collector of the Philippine Islands, then under U.S. jurisdiction, and Sagrada Orden de Predicadores, an ancient Philippine religious order with missions throughout the Far East. The order derived the bulk of its income from large real estate and securities holdings and more modest revenue from the sale of wine, chocolates and other articles for use within its religious missions. The Insular Collector, even while conceding that the religious charity was organized and operated for exempt

upscale shopping center. Stanford University Annual Report 1999, at 15. Some private foundations (e.g., the John D. and Catherine T. MacArthur Foundation) and public charities (The Bishop Estate) have vast land holdings. See, e.g., Andrew C. Revkin, *Nonprofits Facing Ethical Challenges Over Sales of Land*, N.Y.

purposes, argued that it was not operated "exclusively" for such purposes because it derived significant revenue from commercial sources.

In *Trinidad v. Sagrada Orden*,¹¹² the Supreme Court ruled that the charity qualified for tax exemption, holding that the earliest predecessor of § 501(c)(3) permitted exempt organizations to have net income and "said nothing about the source of the income, but makes the destination the ultimate test of exemption."¹¹³ In rejecting the Government's effort to tax the order's income from dividends, interest and rent, the Court stated:¹¹⁴

In using . . . [its] properties to produce the income, . . . [the order] therefore is adhering to and advancing . . . [its] purposes and not stepping aside from them or engaging in a business pursuit."

In discussing the organization's income from the sale of wines and chocolates, the court first observed that the activity did not "amount to engaging in trade in any proper sense of the term." because there was no selling to the public or competition with others.¹¹⁵ It then concluded that since all goods sold by *Sagrada Orden* were either for religious use or "incidental" to the charity's missionary activities, the order's exemption should remain intact.

A careful reading of *Sagrada Orden* reveals that the order was not engaged in any business unrelated to its exempt purposes. The bulk of its revenue was from passive investments, and its sales of wine and chocolates apparently were related to its religious mission. The Court might have ruled against the order if its business activities had been

TIMES, Sept. 16, 2000, at A1.

¹¹²263 U.S. 578 (1924).

¹¹³*Id.* at 581.

¹¹⁴*Id.*

¹¹⁵*Id.*

more extensive and unrelated to its exempt activities. Yet this landmark case gave birth to a venerable but ultimately discredited principle: a tax-exempt organization does not lose its exemption by virtue of the conduct of an unrelated business as long as its profits are dedicated to charitable or other exempt purposes.

Sagrada Orden's "destination of income" test had its heyday in the 1930's and 1940's as a handful of exempt organizations began engaging in commercial activities, either directly or through separate entities ("feeders") that operated a business and distributed the profits to their tax-exempt owners. In one of the earliest cases, the Second Circuit upheld the exempt status of a corporation operating a large bathing beach business near Far Rockaway in New York City because the organization's revenue was paid over to a charitable foundation created by the late owner of the beach.¹¹⁶ In a later and more notorious case, the Third Circuit held that C.F. Mueller Co., then the nation's largest manufacturer of noodles and macaroni, qualified for exemption under § 501(c)(3) because its pasta profits were distributed to its sole shareholder, New York University, for the exclusive benefit of its School of Law.¹¹⁷ This case was working its way through the courts as Congress debated the first UBIT bill, prompting Representative John Dingell's much-cited warning that "the macaroni monopoly will be in the hands of the university . . . and eventually all the noodles produced in this country will be produced by corporations held or created by universities," depriving the Treasury of any tax revenue from an entire

¹¹⁶*Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938). Judge Learned Hand dissented, noting correctly that *Trinidad v. Sagrada Orden* was distinguishable because the business income in that case was "very trifling." 96 F.2d at 779. Judge Hand believed that a "business subsidiary" should not be exempt, without regard to where its income was destined.

¹¹⁷*C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3rd Cir. 1951).

industry.¹¹⁸ Armed with the destination of income test, more nonprofits began engaging in commercial activities having no relationship to their exempt purposes. A few acquired real estate from for-profit taxpayers, usually borrowing to finance the entire purchase, and then leased the property back to the seller for a lengthy term, prompting concerns that exempt organizations were "trading" on their tax exemptions and, left unchecked, would come to "own the great bulk of the commercial and industrial real estate in the country."

¹¹⁹ 2. The 1950 UBIT Legislation

As early as 1942, the Treasury Department prodded Congress to hold hearings on these brewing developments. Two perceived abuses were identified: loss of revenue and unfair competition. Eight years later, when Congress finally acted with President Truman's blessing, the principal articulated concern was the perceived but unproven problem of unfair competition. Both the House and Senate Reports stated:¹²⁰

The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [section 501(c)(3)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemptions to buy an ordinary business. That is, they have acquired the business with little or no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable.

The statute, of course, says nothing about unfair competition, and it is apparent that the

¹¹⁸*Revenue Revision Act of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 579-80 (1950).

¹¹⁹S.REP. NO. 2375, 81st Cong., 2d Sess. 31 (1950). See Note, *Taxation of Sale and Lease-Back Transactions*, 60 YALE L. J. 879 (1951).

¹²⁰H.R.REP. NO. 2319, 81st Cong., 2d Sess. 38 (1950); S.REP. NO. 2375, *supra* note 119, at 28-29.

need for revenue to finance the Korean War, indignation at the few nonprofits seen to be exploiting the system, and more generalized fairness concerns also were influential.¹²¹ The extension of the UBIT to churches in 1969 was grounded on similar concerns and actually was supported by many in the mainstream religious community who feared more draconian measures.¹²²

In formulating the UBIT's first guiding principles, Congress might have relied on the Supreme Court's narrow definition of a "trade or business" in *Higgins* as the basis for exempting most traditional forms of passive investment income from the UBIT. But in an abundance of caution, and also perhaps to clarify the exempt status of income from rental real estate activities (which most likely would be a trade or business even under *Higgins*), Congress went further by including the specific "modifications" now contained in § 512(b). In explaining the exclusions for various types of investment income, the Senate Finance Committee stated:¹²³

Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because your committee believes that 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 and trusts.

The House Ways and Means Committee also recognized that passive income used for

¹²¹See particularly President Truman's admonitions "to improve the fairness of the tax system, to bring in some additional revenue, and to strengthen [the] economy." 96 CONG. REC. 769, 771 (1950) (President's Message to Congress).

¹²²See Stephen Schwarz, *Limiting Religious Tax Exemptions: When Should the Church Render Unto Caesar?*, 29 U.FLA.L. REV. 50, 94-96 (1976).

¹²³S. REP. NO. 2375, *supra* note 119, at 30-31.

exempt purposes should not be taxed because the investments producing such income have "long been recognized as proper for educational and charitable organizations."¹²⁴ In response to sale and leaseback transactions, the 1950 legislation also taxed a portion of rentals from real estate leases (and related leases of personal property) if the lease term was more than five years and the exempt organization used borrowed funds to acquire the property, with exceptions if the purpose of the lease was substantially related to the organization's exempt purposes.¹²⁵ These latter provisions, which proved to be ineffective, were the forerunner of the unrelated debt-financed income rules now found in § 514.

2. Subsequent Developments

The subsequent history of the UBIT is a series of piecemeal changes, most of which are specialized exemptions added at the behest of lobbyists representing a particular nonprofit sub-sector. Every so often, complaints about unfair competition from segments of the small business community are sufficiently loud to prompt Congress to engage in a comprehensive review. The last major episode was in 1987, when Representative J.J. Pickle of Texas presided over hearings conducted by the House Ways and Means Committee's Oversight Subcommittee. In connection with the 1987 hearings and in the face of large budget deficits, Congress and the Treasury Department revisited the policy of excluding passive investment income. The Joint Committee on Taxation floated a

¹²⁴H.R. REP. NO. 2319, *supra* note 120, at 38.

¹²⁵Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 950-952 (amending I.R.C. § 423 as it then existed).

proposal to impose a 5% excise tax on the net investment income of all tax-exempt organizations, including charities, on the theory that the tax-exempt sector benefits from federal spending and should share those costs of government with other institutions.¹²⁶ The Treasury, while acknowledging that the line between a passive investment and an active business was at times thin, supported the longstanding exclusion as applied to public charities because it viewed passive investment income as a proper source of financial support that was not likely to pose a competitive threat. But it expressed concerns, which continue to this day, about whether the exclusion for investment income should be available to non-§ 501(c)(3) organizations, such as labor unions and trade associations.¹²⁷

The 1987 hearings resulted in three volumes of testimony and a discussion draft proposing significant reforms but resulting in no immediate legislation. The periodic whining of the small business lobby continues, but it rarely extends to the expanding types of investments made by the charitable sector. Indeed, as developed below, Congress from time to time has enacted specialized exceptions for nontraditional forms of investment income, and in so doing it has reiterated the view that taxing investment income is inconsistent with the generally tax-free status of exempt organizations.¹²⁸ At the same time, however, another principle surfaced to complicate the debate -- the notion that all

¹²⁶STAFF OF JOINT COMM. ON TAXATION, DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUE PREPARED FOR THE HOUSE COMM. ON WAYS AND MEANS 275-276, 100TH CONG., 1ST SESS. (1987).

¹²⁷*Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight, House Comm. on Ways and Means*, 100th Cong., 1st Sess. 45-47 (1987) [hereinafter "1987 UBIT Hearings"] (statement of O. Donaldson Chapoton). The Treasury also recommended taxing passive income of § 501(c)(4) social welfare organizations to the extent it was expended for lobbying or other purposes outside the scope of § 501(c)(3) under an approach similar to that taken by § 527 with respect to investment income expended for political activities. *Id.* at 46.

¹²⁸*See, e.g.*, S. REP. NO. 760, 95th Cong., 2d Sess. 4, 7 (1978), explaining the rationale for excluding

income from a profit-motivated activity should be taxed at least once even if it inures to the benefit of a charity and whether or not it poses a competitive threat. If that principle were to become the UBIT norm, it would depart from the conventional wisdom and have broader tax policy ramifications.

Fifty years of history, experience and endless discussion have not yielded much more than speculation as to whether the stated goals of the UBIT are coherent and, if unfair competition is the culprit, whether the current structure of the tax provides a satisfactory solution. A familiar lament is the lack of any empirical data validating the supposed evils of unfair competition. Periodically, questions are raised as to whether the "trade or business" and "relatedness" tests are appropriate to police inappropriate commercial behavior. The assumption that nonprofit organizations would compete unfairly in their active "business" pursuits without the UBIT, but pose no competitive threat when investing their endowment, renting their real estate, or exploiting their intellectual capital is accepted but unexplained. Some academic commentary has called for repeal of the UBIT,¹²⁹ while others question whether unfair competition is even relevant, preferring to shift the inquiry to economic efficiency.¹³⁰

Having maneuvered through this fog, we shall accept the conventional wisdom, assume the UBIT should be retained, more or less in its current form, and proceed to survey the current state of the law as it affects investments, broadly defined.

D. Basic Line Drawing Under the UBIT

income from securities lending from UBTI.

¹²⁹See, e.g., Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982).

1. Exclusions for Passive Investment Income

The most significant exclusions from UBTI are for traditional forms of passive investment income, such as dividends, interest, annuities, rents and royalties,¹³¹ as well as gains from the sale, exchange or other disposition of property other than inventory and property primarily held for sale to customers in the ordinary course of a trade or business.¹³² Gain on the sale of depreciable property used in an unrelated trade or business is taxable to the extent it is treated as ordinary income under the depreciation recapture provisions.¹³³ This traditional list of "passive" items has been expanded to exclude income from some modern risk management strategies such as options, securities lending transactions, notional principal contracts and short sales.¹³⁴ The exclusions generally are not available, however, for income derived from debt-financed property that is unrelated to the organization's exempt functions.¹³⁵ In addition, some forms of otherwise excludable investment income received from a 50% or more controlled subsidiary may be taxable,¹³⁶ and an exempt organization's distributive share of certain income from pass-through entities such as partnerships and S corporations also is part of UBTI.¹³⁷ If an activity produces a type of income that does not snugly fit within one of the specific statutory exclusions, the inquiry becomes more complex, and the usual UBIT

¹³⁰Henry Hansmann, *Unfair Competition and the Unrelated Business Tax*, 75 VA. L. REV. 605 (1989).

¹³¹I.R.C. §§ 512(b)(1)-(4).

¹³²I.R.C. § 512(b)(5).

¹³³Treas. Reg. § 1.1245-6(b).

¹³⁴Treas. Reg. § 1.512(b)-1(a)(1). *See also* I.R.C. §§ 512(a)(5); 512(b)(5). As to short sales, *see* Rev. Rul. 95-8, 1995-1 C.B. 108. *See infra* notes 176-192 and accompanying text.

¹³⁵I.R.C. § 512(b)(4).

¹³⁶I.R.C. § 512(b)(13). *See infra* notes 260-275 and accompanying text.

¹³⁷I.R.C. §§ 512(c), (e). *See infra* notes 241-257 and accompanying text.

questions must be asked and answered: (1) is the activity a "trade or business"; (2) is it "regularly carried on?"; and (3) if the answers to (1) and (2) are yes, is the activity substantially related to the organization's exempt purposes?

2. The UBIT's Concept of "Trade or Business"

a. *Definition of "Trade or Business."* The regulations, emphasizing that the primary objective of the UBIT was to eliminate a source of unfair competition, first look to the characteristics of a trade or business within the meaning of § 162. Any activity "carried on for the production of income [sounds like § 212] and which otherwise possesses the characteristics required to constitute trade or business within the meaning of section 162 [this seemingly evicts "investment" activities even without the § 512(b) exclusions for passive investment income items] . . . presents sufficient likelihood of unfair competition to be within the policy of the tax."¹³⁸ From this, the regulations give "trade or business" the same meaning it has in § 162 (whatever that meaning may be) and, repeating language from § 513(c), they provide that a trade or business "generally includes any activity carried on for the production of income from the sale of goods or performance of services."¹³⁹

¹³⁸Treas. Reg. § 1.513-1(b).

¹³⁹*Id.* The function of the "trade or business" language in § 513(c) is to codify the fragmentation concept that the Service previously articulated in regulations. Under this approach, which is unique to the UBIT, an unrelated business need not be wholly separate from the organization's exempt activities. Thus, the sale of pharmaceutical supplies to the general public by a hospital pharmacy does not escape the UBIT because the pharmacy also furnishes supplies to the hospital and its patients. Similarly, even though the publication of a magazine or journal may be related to an organization's exempt purposes, its advertising activity will be

In interpreting the UBIT's concept of a trade or business, many courts have adopted an expansive view that at first glance seems to embrace both business (§ 162) and investment (§ 212) activities. Virtually all courts of appeals to consider the question have accepted the Service's profit motive test, under which a trade or business includes any activity carried on by an exempt organization with the hope and intent of making a profit.¹⁴⁰ The Supreme Court embraced this test in *United States v. American Bar Endowment*,¹⁴¹ where it held that a § 501(c)(3) affiliate of the American Bar Association was taxable on income derived from a group insurance program offered to ABA members.¹⁴² In a line of pro-taxpayer decisions, the Tax Court may have retreated subtly from a pure profit motive standard, stating in one case that a desire to make money, standing alone, is not sufficient evidence of a trade or business unless "the primary purpose for engaging in the activity must be for profit."¹⁴³ In most of the UBIT cases where the

carved out and treated as a distinct and taxable trade or business unrelated to exempt purposes. The legislative and anecdotal history confirm that the purpose of § 513(c) was to strengthen the Service's hand in taxing advertising revenue. *See, e.g., United States v. American College of Physicians*, 475 U.S. 834 (1986).

¹⁴⁰*See, e.g., Henry E. & Nancy Horton Bartels Trust v. United States*, 209 F.3d 147 (2d Cir. 2000); *Professional Insurance Agents of Michigan v. Commissioner*, 726 F.2d 1097 (6th Cir. 1984); *Carolinas Farm & Power Equipment Dealers v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Clarence LaBelle Post No. 217, Veterans of Foreign Wars of the United States v. United States*, 580 F.2d 270 (8th Cir. 1978).

¹⁴¹477 U.S. 105 (1986)

¹⁴²The members were required to pay their insurance "dividends" back to the ABA, which had argued that this revenue represented nontaxable charitable contributions. *See also Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990), where the Court applied the profit motive test in holding that a social club could deduct losses from sales of good and beverages to nonmembers against taxable investment income only if the nonmember sales were undertaken with a profit motive.

¹⁴³*Alumni Ass'n of Univ. of Oregon v. Commissioner*, 71 T.C.M. (CCH) 2093 (1996), *aff'd*, 193 F.3d 1098 (9th Cir. 2000). *See also Ohio Farm Bureau Federation, Inc. v. Commissioner*, 106 T.C. 222 (1996), where the Tax Court, relying on the Supreme Court's definition of "trade or business" in *Commissioner v. Groetzinger*, *supra* note 36, appeared to retreat from a pure profit motive standard and reasoned that "the level of activity remains an important component of the trade or business standard." 106 T.C. at 234. The court went on to hold that income realized by an agricultural organization from a covenant not to compete was not derived from a trade or business and thus did not constitute UBTI.

definition of "trade or business" has been an issue, the adoption of a profit motive standard also was used to buttress a more important point: that the presence or absence of competition with for-profit taxpayers, while an important objective of the UBIT, is not determinative. Rather, the more critical question is whether the organization has a profit motive and regularly engages in the activity in a commercial manner.¹⁴⁴ If one searches for an analogous inquiry under general tax principles, it would be whether a taxpayer has a sufficient profit motive to take deductions under § 162 or § 212 or, conversely, whether a lack of profit motive converts the activity into a mere personal indulgence -- a hobby.

b. *The Active/Passive Line.* A parallel and often confusing conceptual line that has emerged from the UBIT jurisprudence is between income from "active" and "passive" activities. This distinction has been at the heart of controversies over whether revenue from the rental of mailing lists qualifies as an excludable royalty under § 512(b)(2). In 1981, stating that "[t]o be a royalty, a payment must relate to the use of a valuable right," the Service ruled that revenue received by a labor organization from various "business" enterprises for the use of its trademark and similar properties were excludable royalties even though, without the royalty exclusion, the income was from an unrelated trade or business.¹⁴⁵ It later backtracked, arguing in one of the early mailing list cases that the term "royalty" must be construed in light of the Congressional policy to eliminate unfair competition.¹⁴⁶ Under this interpretation, only royalties from passive sources were excludable, while royalties derived from the conduct of an active business (e.g., renting a

¹⁴⁴For an isolated case taking a contrary view, see *Hope School v. United States*, 612 F.2d 298 (7th Cir. 1980).

mailing list) were taxable. The unproven premise was that unfair competition only results when an exempt organization devotes time and effort to an income-producing activity.

Although the Claims Court accepted the Service's active/passive distinction,¹⁴⁷ the Tax Court rejected it in a series of cases, concluding that as written § 512(b) is not limited to royalties from passive sources.¹⁴⁸ Implicit in the Tax Court's line of pro-taxpayer mailing list cases is the notion that a royalty need not be a form of passive investment income and could emanate from the conduct of an active business. Other courts have taken a somewhat different approach, focusing on whether the exempt organization performs significant services in connection with a royalty-related activity. For example, in holding that the Sierra Club's mailing list rentals qualified for the royalty exclusion, the Ninth Circuit, relying on two dictionaries, concluded that royalties are passive by definition and thus cannot include compensation for services rendered by the owner of the licensed property.¹⁴⁹ The court etched a line between "passive" income that posed no threat of unfair competition and payments for services, which somehow do pose a threat. This approach rejects the premise of the earlier cases that the royalty exclusion can apply even if the income is derived from an active trade or business.

¹⁴⁵Rev. Rul. 81-178, 1981-2 C.B. 135.

¹⁴⁶*See* *Disabled American Veterans v. United States*, 227 Ct.Cl. 474, 650 F.2d 1178 (1981).

¹⁴⁷*Id.* The mailing list rentals in the *DAV-I* case were found to be the product of extensive business activity.

¹⁴⁸*See, e.g.,* *Sierra Club v. Commissioner*, 103 T.C. 307 (1994), *aff'd*, 86 F.3d 1526 (9th Cir. 1996); *Common Cause v. Commissioner*, 112 T.C. 332 (1999).

¹⁴⁹*Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996). *See also* *Louisiana Credit League v. United States*, 693 F.2d 525 (5th Cir. 1982), holding that fees received by a tax-exempt business league from endorsement and promotion of insurance were taxable because the organization performed significant promotional and marketing services.

3. Summary and Conclusions

Few if any of the UBIT cases attempt to draw any bright line between business and investment activities. In most simple contexts, at least, and even in some more complex situations (e.g., real estate), § 512(b) makes line drawing unnecessary by providing specific exclusions for dividends, interest, royalties and other receipts from passive investment activities.

If a particular activity or income item does not fall within one of the excluded categories or some other exception, however, the trade or business vs. investment issue must be confronted. When this occurs, the general tax principles discussed in Part II are of relatively little assistance, even though courts may rely on a non-UBIT definition if it bolsters a desired statutory interpretation or outcome. Why is this so? First, as noted earlier, the Code uses the term "trade or business" in so many different contexts that an all-purpose definition is both "unhelpful" and even "precarious."¹⁵⁰ Second, virtually all the precedents involve individuals, not entities. Indeed, the distinction between business and investment is generally irrelevant for for-profit taxable entities, at least in the domestic setting because a profit motive is assumed for all their activities. Third, the UBIT's concept of a trade or business is clouded by uncertainty over the degree to which unfair competition, commerciality, level of activity, or other facts and circumstances are the determinants driving the tax. Fourth, as the ensuing discussion will demonstrate, some of the most challenging UBIT questions have little or nothing to do with business/investment

¹⁵⁰Commissioner v. Groetzinger, *supra* note 36, at 36.

line drawing but rather implicate the broader question of whether business income should be subject to at least one level of tax. Fifth, the crazy quilt that the UBIT has become is often the result of activities that arouse sufficient indignation to capture the tax collector's attention (e.g., exclusive marketing deals) or, conversely, the product of effective lobbying by narrowly affected sub-sectors (e.g., the exceptions for trade shows, bingo, pole rentals, and WWL in New Orleans).

In the last analysis, rather than trying to define a trade or business for UBIT purposes, perhaps a more productive inquiry would be to specify more clearly the types of "investment" activities and income that are (and should be) beyond the scope of any tax imposed on exempt organizations. That inquiry, to which we next turn, also raises broader issues on the rationale for and scope of exemption that to date remain unresolved.

E. Securities and Related Investments

1. Interest and Dividends

Congress no doubt contemplated that few controversies would arise over the exclusion for interest and dividends under § 512(b)(1). Over the years, this exclusion has been extended to payments with respect to securities loans and loan commitment fees. The regulations go further, applying § 512(b)(1) to income from notional principal contracts and "other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. . ."¹⁵¹ These exclusions are not available, however, if the income is derived from debt-financed property, or (except in the case of

dividends) if it is received from a 50-percent or more controlled subsidiary.¹⁵²

a. Interest. Any payment that clearly represents payment for the use or forbearance of money will have little difficulty qualifying as interest even if it is not labelled as such. For example, prepaid interest in the form of "points" on a loan and loan guarantee fees are excluded if they are the equivalent of interest, but service fees do not qualify as interest even if they were paid in connection with a loan transaction.¹⁵³

The major interpretive issues involve the newer breed of financial instruments, such as contingent debt and derivatives, that may not be so easily characterized. Contingent debt, for example, may provide a hybrid type of return on investment -- a combination of compensation for the use of money (interest) and an equity participation component. The central tax concern for the issuer is whether payments made are deductible interest or nondeductible dividends. For the taxable holder, contingent debt instruments implicate the dreaded time value of money provisions, with the tax collector's agenda focusing on timing and character of income. Tax-exempt holders of hybrid corporate debt normally are indifferent to the classification because dividends and interest are excludable under § 512(b). But if a hybrid instrument is classified as a joint venture with the issuer or an interest in the issuer's assets, it could generate UBTI to the holder.¹⁵⁴

¹⁵¹Treas. Reg. § 1.512(b)-1(a)(1).

¹⁵²I.R.C. §§ 512(b)(4), 512(b)(13); Treas. Reg. § 1.512(b)-1(a)(2). For a discussion of debt-financed income, *see infra* notes 167-175 and accompanying text, and for controlled subsidiaries *see infra* notes 258-275 and accompanying text.

¹⁵³As to service fees, *see* Rev. Rul. 79-349, 1979-2 C.B. 233. As to points, *cf.* Rev. Rul. 69-188, 1969-1 C.B. 54.

¹⁵⁴This issue also arises in connection with real estate loans providing for fixed interest and additional contingent interest based on a profit participation. In determining what is "interest" for purposes of qualifying as a real estate investment trust, payments based on income or profits generally do not qualify (I.R.C. § 856(f)), but no similar restriction applies for UBIT purposes and guidance on this point is sparse.

b. Dividends. Assuming no debt-financed property problems, the exclusion of dividends is well accepted with a few arcane exceptions. This does not necessarily mean that exempt shareholders are not taxed on their share of corporate income. Since most dividends are paid by C corporations with ample earnings and profits, tax in varying degrees (depending on available corporate tax preferences) has been paid at the corporate level without relief for amounts attributable to tax-exempt shareholders. Exceptions to this principle of shareholder-level exclusion usually are aimed at "dividends" that have not already been subject to a U.S. entity-level tax. Thus, distributions from real estate investment trusts (REITS),¹⁵⁵ which normally are treated as excludable dividends,¹⁵⁶ may be included in UBTI if received by an otherwise exempt § 401(a) pension trust in limited circumstances.¹⁵⁷ Second, exempt organizations holding a "residual interest" in a Real Estate Mortgage Investment Conduit ("REMIC"),¹⁵⁸ either directly or through a REIT, will

¹⁵⁵A real estate investment trust ("REIT") is an investment pool that invests primarily in real estate. REITS, like more conventional mutual funds, are treated as pass-through entities for tax purposes if certain detailed requirements are met. Principal requirements are that 75% of a REIT's gross income must be derived from passive real estate activities, the ownership must be widely held, and 95% of a REIT's taxable income must be distributed to shareholders. Qualified REITS generally do not pay any entity-level tax on income that is distributed to shareholders. Instead, REIT distributions are taxable to shareholders as ordinary income or capital gain, with characterization determined at the entity level. *See generally* I.R.C. §§ 856-860.

¹⁵⁶*See* Treas. Reg. § 1.856-2(e)(7), providing that § 316, which defines "dividend" for purposes of Subchapter C, applies to REIT distributions.

¹⁵⁷I.R.C. § 856(h)(3). This provision applies only to pension trusts owning more than 10% of a REIT and only to the extent the REIT would have UBTI if it were subject to the UBIT.

¹⁵⁸A REMIC is a fixed pool of mortgages with multiple classes of interests held by investors. REMICs are pass-through entities governed by a customized tax regime. *See* I.R.C. §§ 860A-860E. Holders of "regular" interests (generally, an interest with fixed terms in which the holder has a right to receive a specified principal amount) include in income that portion of the REMIC's income that would be recognized by an accrual method holder of a debt instrument with the same terms as the regular interest. Holders of "residual" interests take into account all the net income of the REMIC that is not taken into account by holders of the regular interests.

be taxable on a portion of the income generated from that interest¹⁵⁹ under complex look-through rules in the case of a REIT. Third, since 1997 the dividend exclusion does not apply to a narrow type of otherwise excludable Subpart F income (i.e., foreign source income received by certain 10%-or-more U.S. shareholders of controlled foreign corporations) is treated as gross income derived from an unrelated trade or business to the extent the amount is attributable to insurance income (as defined in § 953) which, if it had been derived directly by the U.S. tax-exempt shareholder, would be treated as gross income from an unrelated trade or business.¹⁶⁰ Fourth, now that certain exempt organizations may be permissible shareholders of S corporations, they must take into account their distributive share of various S corporation income and deduction items (including dividends, interest and capital gains realized by the S corporation) in determining UBTI. The unique treatment of S corporation investments is discussed later in this paper.¹⁶¹ The policy underlying several of these exceptions is not grounded on the business/investment distinction but is based on a desire to ensure that at least one level of tax is paid on certain types of income passing through to tax-exempt organizations from

¹⁵⁹I.R.C. §§ 860E(b); 856(c)(5)(E).

¹⁶⁰I.R.C. § 512(b)(17)(A). Exceptions, of importance to those who understand and can benefit from them, are provided for income from captive insurance activities that insure the exempt organization itself, its affiliates, or its directors, officers and other key personnel with respect to their services to the organization. See I.R.C. § 512(b)(17)(B). Ordinarily, § 512(b)(17) should not be a problem for routine portfolio investments because the exempt organization will not be a 10%-or-more U.S. shareholder. Reduced ownership standards apply, however, to "related party insurance income" (RPPI). I.R.C. § 953(c). RPPI is any insurance income attributable to a policy of insurance or reinsurance with respect to which the person insured (directly or indirectly) is a U.S. shareholder of the foreign corporation or a person related to such shareholder. I.R.C. § 953(c)(2). In applying Subpart F to RPPI and subject to several exceptions, the term "U.S. shareholder" is any U.S. person who owns any stock of the foreign corporation, and the foreign corporation is a CFC if 25% or more of the corporation's stock is owned by such U.S. shareholders. I.R.C. § 953(c)(1).

¹⁶¹See *infra* notes 254-257 and accompanying text, which also discusses the treatment of holdings in other

entities treated as conduits for tax purposes.

c. *Foreign Investments: Special Problems.* Direct investments in foreign securities also may raise other UBIT issues. Some countries impose a withholding tax on dividends paid to nonresident investors whether or not the investor is tax-exempt in its home jurisdiction. Treaties with a few of these countries permit a portion of the withholding tax to be reclaimed through procedures that range from the relatively straightforward to cumbersome and worse. Taxable investors may take a foreign tax credit with respect to the nonreclaimable foreign tax on dividends and interest, but the credit is essentially worthless to tax-exempt investors except in the rare case where they may apply it against tax generated on foreign source UBTI. In the last analysis, nonreclaimable foreign taxes are simply a cost of global investing and must be taken into account in evaluating the investor's overall return.

As noted earlier, another potential irritant is § 512(b)(17), which applies a look-through approach to include in UBTI any Subpart F insurance income (as defined in § 953) which, if it had been received directly by the exempt organization, would be treated as gross income from an unrelated trade or business, less directly connected deductions. Section 512(b)(17) stands as an exception to the Service's private ruling policy which, with one isolated departure, has consistently treated Subpart F inclusions of U.S. tax-exempt shareholders as excludable dividends.¹⁶² At one time, Congress threatened to go further by adopting a more comprehensive look-through approach treating all Subpart

pass-through entities, such as partnerships and limited liability companies.

¹⁶²See, e.g., P.L.R. 94-07-007 (Nov. 12, 1993); P.L.R. 90-27-051 (April 13, 1990). For the one departure, see P.L.R. 90-430-39 (July 30, 1990).

F income of an exempt organization as taxable to the extent it would have been UBTI if received directly by the organization. The theory was that income from an unrelated business, wherever conducted, should be subject to at least one level of tax, at least in situations where a U.S. tax-exempt investor was a 10%-or-greater shareholder. The legislation ultimately enacted was confined to the insurance sub-category, on the rationale that it was necessary to tax offshore insurance activities of exempt organizations, at least those insuring third-party risks, to prevent unfair competition.¹⁶³

These special issues for foreign investments are both a minor annoyance for global investors and, as discussed later, an opportunity to use an indirect route to avoid UBIT.¹⁶⁴

They are far more troublesome for charitable remainder trusts that directly invest in stocks of foreign companies.¹⁶⁵

2. Gains and Losses from Dispositions of Property

The exclusion for gains and losses from sales, exchanges and other dispositions of property (including casualty losses and involuntary conversions) extends to virtually any type of investment gain but not to dispositions of "dealer" property, such as inventory and other property held primarily for sale to customers in the ordinary course of a trade or business.¹⁶⁶ As with other types of passive investment income, the exclusion for gains and

¹⁶³H. REP. NO. 104-586, 104th Cong., 2d Sess. 82-83 (1996).

¹⁶⁴*See infra* notes 199-205 and accompanying text.

¹⁶⁵*See infra* notes 296-301 and accompanying text.

¹⁶⁶I.R.C. § 512(b)(5). This exclusion also does not apply to certain transactions involving the cutting of timber if the taxpayer elects under § 631(a) to treat the cutting as a sale or exchange, or to amounts that would be treated as ordinary income under the depreciation recaptures rules in §§ 1245 or 1250. *See, e.g.*, Treas. Reg. § 1.1245-6(b).

losses does not apply to dispositions of debt-financed property (to the extent of the debt/basis percentage), whether or not the property is held for investment or used in an unrelated trade or business.

The § 512(b)(5) exclusion raises relatively few unique issues. Absent debt-financing, the typical types of gains realized by investors (and traders) in securities are excluded. To the extent investments are made in securities denominated in a foreign currency, a portion of the overall gain or loss on the transaction may be attributable to fluctuation in the value of the currency relative to the dollar. For taxable investors, this currency gain or loss is treated as ordinary rather than capital under § 988. Since § 512(b)(5) is not limited to capital gains and losses, any § 988 gains or losses that are part of a routine investment program also should be excluded from UBTI. The principal trouble spots relate to sales of real estate and are reminiscent of similar issues confronting for-profit taxpayers who seek to classify themselves as investors rather than dealers to qualify for preferential capital gains rates.

3. Unrelated Debt-Financed Income

If an exempt organization borrows to acquire income-producing property, all or part of the income derived from the property less allocable deductions may be included in UBTI even if the income is not connected with a trade or business and otherwise would have been excluded under § 512(b). The extension of the UBIT in 1969 to income from debt-financed property was in response to several transactions that were viewed as abusive attempts by exempt organizations to trade on their tax-exempt status by acquiring

property on credit and then leasing it back to the seller.¹⁶⁷ Since debt-financed property is the topic of the final panel at the conference, the global policy issues will be left to others, and this paper will limit its attention to selective issue spotting with respect to securities and real estate investments.

In general, § 514 provides that an exempt organization must include in UBTI a certain percentage -- known as the "debt/basis fraction" -- of gross income from debt-financed property less a similar percentage of allocable deductions.¹⁶⁸ "Debt-financed property" is any tangible or intangible property held for the production of income with respect to which there is an "acquisition indebtedness" at any time during the taxable year, and includes property owned by an entity taxed as a partnership.¹⁶⁹ "Acquisition indebtedness" is any outstanding debt incurred to acquire or improve property, including in some cases debt incurred before or after the acquisition or improvement.¹⁷⁰ The debt-basis fraction, which is used to determine the percentage of income to be included in UBTI, is the ratio of the average acquisition indebtedness during the year over the average adjusted basis of the property.¹⁷¹ The fraction varies as the debt is amortized and the basis is adjusted for depreciation. The unrelated debt-financed income rules extend not only to dividends and interest but also to capital gains from securities with respect there is an

¹⁶⁷*See, e.g.,* Commissioner v. Brown, 380 U.S. 563 (1965); University Hill Found. v. Commissioner, 51 T.C. 548 (1969), *rev'd*, 446 F.2d 701 (9th Cir. 1971), *cert. denied*, 405 U.S. 965 (1972). For an excellent discussion of the historical background and tenuous rationale underlying § 514, *see* Suzanne Ross McDowell, *Taxing Leveraged Investments of Charitable Organizations: What is the Rationale?*, 39 CASE WEST. L. REV. 705 (1988).

¹⁶⁸I.R.C. § 514(a)(1)-(3).

¹⁶⁹I.R.C. § 514(b)(1); Treas. Reg. § 1.514(b)-1(a). This definition is subject to several exceptions, most of which exempt property related to the organization's exempt purposes. I.R.C. § 514(b)(1).

¹⁷⁰I.R.C. § 514(c).

"acquisition indebtedness" at any time during the twelve-month period ending with the date of their disposition, but gains may be offset by the appropriate percentage of capital losses from debt-financed securities.

Although the debt-financed property rules have their greatest impact on real estate investment, they also can affect stocks and bonds acquired through margin accounts. Consider the plight of the Henry E. & Nancy Horton Bartels Trust, a supporting organization for the benefit of the University of New Haven, which purchased securities on margin as part of its routine investment program.¹⁷² After including a portion of its dividend and interest income in UBTI, the trust sued for a refund, claiming that it should avoid the grasp of § 514 because: (1) its margin trading activities were not a "trade or business;" (2) the trust gained no unfair competitive advantage over taxable entities from its margin trading; (3) the leveraged securities were not within the definition of debt-financed property; and (4) if they were debt-financed property, the investment activity was "inherent" and thus substantially related to its exempt purposes. The trust's "no trade or business" argument faithfully relied on many of the cases surveyed in Part II of this paper, all of which support the proposition that investing in securities is not a trade or business. But the court could not avoid the plain language of the statute because it makes no difference under § 514 whether or not investing on margin is a trade or business, or whether the activity poses a threat of unfair competition.¹⁷³ Citing earlier cases that also struggled to justify the UBIT's stated rationale when applied to margin trading, the court

¹⁷¹I.R.C. § 514(a)(1).

¹⁷²Henry E. & Nancy Horton Bartels Trust for Benefit of the University of New Haven v. United States, *supra* note 140.

conceded that Congress went beyond the evil it sought to correct.¹⁷⁴

The Second Circuit's decision in *Bartels Trust* properly interprets the language of § 514, but in so doing it exposes the mysterious reach of the debt-financed property rules. The message for tax-averse exempt organization investors is clear: direct or indirect acquisition of income-producing property with borrowed funds is to be avoided because it will generate some UBTI. This trap affects investors in hedge funds (organized as partnerships) that borrow to acquire investment securities. But as discussed below, not all "leverage" is considered "debt" for § 514 purposes. As it gradually adapted to new investment strategies, the Service has reined in § 514 by characterizing securities lending, short sales, swaps, and other hedging strategies as transactions that create liabilities or obligations falling short of "acquisition indebtedness" because no direct borrowing is involved. Even in some situations where actual borrowing has occurred, the Service's private ruling policy has been forgiving where the indebtedness is "transitory" and part of a routine investment program.¹⁷⁵

¹⁷³*Id.* at 150-154.

¹⁷⁴*Id.* at 155-156. *See also* Kern County Electrical Pension Fund v. Commissioner, 96 T.C. 845 (1991), *aff'd by unpublished opinion*, 988 F.2d 120 (9th Cir. 1993); Eliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.3d 347 (3d Cir. 1980).

¹⁷⁵*See, e.g.*, P.L.R. 87-21-107 (Feb. 27, 1987), involving temporary borrowings by a title holding subsidiary of a § 501(c)(3) organization (that resembles TIAA/CREF before it lost its exemption) to help manage cash flow in connection with its ongoing investment program. The Service ruled that this type of short-term borrowing was an ordinary and routine investment activity. *See also* P.L.R. 96-44-063 (Aug. 5, 1996), ruling that similar borrowings by a tax-exempt profit-sharing plan were not "debts" incurred to purchase or carry investments but rather part of the ordinary and routine activities of the trust to facilitate transfers and distributions; P.L.R. 2000-10-061 (Dec. 17, 1999), ruling that short-term borrowing to facilitate distributions by a collective investment pool for employee benefit plans did not create "acquisition indebtedness." Notably, perhaps, these rulings involve cash management for employee benefit plans. Sensible as it may be, it is unlikely that the de minimis principle in these rulings will find its way into a more generally applicable published ruling. Thus, for planning purposes the prudent course is to assume that any connection between borrowing and the acquisition of income-producing property may generate at least some UBTI. This can be a particular catastrophe in a charitable remainder trust. *See infra* notes 296-301

4. Other Forms of Investment Income

a. Options. An early example of the Service's evolutionary understanding of emerging investment strategies is its treatment of income from the lapse or termination of options. Exempt organizations, like other sophisticated investors, buy and sell traded options on common stocks (and other securities) to generate income and hedge against declines in value. In a 1966 published ruling, the Service took the position that the sale of either put or call options was an unrelated trade or business rather than an investment activity.¹⁷⁶ The confused rationale was that since organizations could realize income from the sale of options without selling the underlying security, the transactions were "a separate activity from the management of its portfolio."¹⁷⁷ The ruling then addressed whether, notwithstanding the conclusion on the "trade or business" question, option premiums were excludable as capital gains under § 512(b)(5). It concluded that if the option were exercised, the premium was an adjustment to the cost or amount realized and thus was excluded as a capital gain, but if the option lapsed or was terminated, any realized gain was ordinary income includible in UBTI.

But never mind! Exempt organization lobbyists, having failed in their efforts to educate the Service, turned to Congress, which obliged by amending § 512(b)(5) in 1976 to cover gains on the lapse or termination of options. The legislative history noted that taxing this type of income was "inconsistent with the generally tax-free treatment accorded

and accompanying text.

¹⁷⁶Rev. Rul. 66-47, 1966-1 C.B. 149.

¹⁷⁷*Id.*

to exempt organizations, income from investment activities."¹⁷⁸ This amendment easily covers most plain vanilla options but not necessarily all hybrid instruments.

b. Securities Lending. Yale's David Swensen characterizes securities lending transactions as a form of hidden leverage. He describes the motivation for securities lending as follows:¹⁷⁹

Most large institutional investors conduct security loan programs which involve lending equity and debt securities to third parties, providing modest incremental income to the Investor. Security borrowers, generally Wall Street financial concerns, require the loans to create short positions or cover failed trades. The lender receives cash collateral to secure the asset on loan, making that aspect of the transaction quite safe. The lender pays a below-market rate of interest on the cash collateral, expecting to reinvest the cash at a higher rate. This aspect of the transaction takes on the risk characteristics of the reinvestment vehicle. Security lending places the entire amount of the transaction at risk to generate the hoped-for spread between the borrowing and lending rates.

Because the owner of securities on loan retains ownership, along with the attendant economic consequences, security lending activity provides little disruption to the portfolio. Investors find it easy to forget about security lending, relegating it to back-office status. Security lending rarely appears on investment committee agendas, treated like other functions performed by custodian banks. If considered at all, committees likely view the process as a low-risk method of offsetting a portion of the bank custody fee.

Prior to 1978, the UBIT consequences of securities lending were unsettled because the activity conceivably could be characterized as a "trade or business" and no specific

¹⁷⁸S. REP. NO. 1172, 94th Cong., 2d Sess. 3 (1976).

¹⁷⁹Swensen, *supra* note 83, at 144-145. Swensen goes on to describe how securities lending generated handsome returns in the 1970's but became less attractive when tax-exempt institutional investors (mostly pension funds) entered the market, contributing to unattractive returns. *Id.* at 145-146. Some forms of speculative securities lending have resulted in large losses, the most notable example being The Common Fund's \$138 million debacle in the early 1990's when a "rogue trader" handling one of its portfolios failed to hedge and made a wrong bet on the direction of the stock market. *Id.* at 146-147. See also Michael Gonzalez, *SEC Starts Inquiry on Whether Trader Violated Rules Involving College Fund*, WALL ST. J., July 3,

§ 512(b) exclusion was available.¹⁸⁰ After a barrage of lobbying by affected exempt organizations, the Service backed off, ruling that various forms of income derived from securities lending transactions were not the type of income that Congress intended to tax.¹⁸¹ In so ruling, the Service did not squarely find the absence of a trade or business but rather took the position that certain types of investment income, even though not expressly enumerated in § 512(b), were intended to be excluded because they were substantially similar to the items listed and were derived "from ordinary and routine investments."¹⁸² Congress definitively resolved the issue in 1978 by amending § 512(b)(1) to specifically exclude payments with respect to securities loans, as defined in § 512(a)(5). As with options, the Senate Finance Committee emphasized the UBIT's distinction between business and investment income:¹⁸³

. . . it is contemplated that the activity of an exempt organization in merely making available its securities for loan is not to affect its status as an investor with respect to those securities nor is it to result in the organization's being treated as being in the trade or business of selling or lending securities so as to result in the gains from such securities being treated as subject to the unrelated business income tax.

c. Short Sales. A short sale is a transaction in which an investor sells a security it does not own in anticipation of a decline in market value. Investors use short sales to reduce the risk in a portfolio and to enhance total return. To implement a typical short

1995, at A2.

¹⁸⁰See, e.g., G.C.M. 36,948 (Dec. 10, 1976), where the Service concluded that securities lending constituted an unrelated trade or business even though the income derived was within the spirit of the § 512(b) exclusions for passive investment income.

¹⁸¹Rev. Rul. 78-88, 1978-1 C.B. 163.

¹⁸²*Id.* This assumes the securities were not inventory or other forms of dealer property. See also Treas. Reg. § 1.512(b)-1(b).

¹⁸³S. REP. NO. 760, 95th Cong., 2d Sess. 4 (1978).

sale transaction, the investor must borrow the security to make delivery to the buyer and ultimately must replace the borrowed security by purchasing it at the market price at the time of replacement. While the transaction remains open, the investor must pay the lender, typically a broker, amounts equal to the dividends or interest accruing during the term of the loan. Under the contractual relationship between the investor and the lender, the investor must maintain sufficient collateral to meet margin requirements until the short position is closed out.

The UBIT issues raised by short sales are: (1) is the activity a "trade or business" because it involves securities that may not currently be in the organization's portfolio; (2) does the income derived from a short sale fit within any of the § 512(b) exclusions; and (3) in any event, does the organization's sale of borrowed stock implicate the debt-financed property rules? The answers were a long time in coming, but the Service finally ruled in 1995 that a short sale where the investor fully collateralized 150% of the value of the shorted security did not result in any UBTI.¹⁸⁴ The Service concluded that transaction did not create "acquisition indebtedness" within the meaning of § 514(c) because it created an "obligation, not an indebtedness." The Service's tolerant position on short sales is particularly helpful for investors employing a strategy involving the simultaneous acquisition of long and short positions to neutralize risk and enhance overall return.

d. Notional Principal Contracts and Other Derivatives. Sophisticated investors utilize various forms of leverage to hedge risk and enhance return on their portfolios. The

¹⁸⁴Rev. Rul. 95-8, 1995-1 C.B. 107. In an earlier technical advice memorandum, the Service found no acquisition indebtedness from a short sale even though the facts did not indicate whether more than 100%

goal is to generate returns in excess of the borrowing costs. Derivatives provide a source of "implicit leverage," which "stems from holding positions that embody greater risk than contemplated by the asset class within which they are categorized."¹⁸⁵ Defined broadly, derivatives are "financial instruments whose value is determined by [or "derived from"] the price of some underlying asset such as stocks, bonds, currencies, or commodities."¹⁸⁶

Derivatives include plain vanilla futures and options contracts, along with a vast array of more complex financial products that have appeared on the scene, along with the usual argot of the trade that ensures their aura of mystery except to those in the know.¹⁸⁷

Derivatives blossomed in the 1990's, enjoying a mixed reputation. Like cholesterol, there are good derivatives (to hedge risk) and bad derivatives (to speculate, using lots of leverage).¹⁸⁸

The tax law collectively refers to most derivatives as "notional principal contracts," which are broadly defined as "financial instruments under which one party to the contract, in exchange for a specified consideration from the other contractual party (the counterparty), makes payments to the counterparty at designated intervals,"¹⁸⁹ with the

of the short sale proceeds would be deposited with the broker. T.A.M. 96-42-051 (July 22, 1996).

¹⁸⁵SWENSEN, *supra* note 83, at 142.

¹⁸⁶MALKIEL, *supra* note 83, at 278.

¹⁸⁷The author, from his West Coast outpost, is not particularly in the know but has collected the names of some derivatives that have emigrated from the Hamptons and made it past the Rockies and Sierra Nevada. They include: swaps, caps, floors, collars and floaters.

¹⁸⁸For a readable explanation, see Burton Malkiel's colorful chapter entitled, "How Pork Bellies Acquired an Ivy League Suit: A Primer on Derivatives," in MALKIEL, *supra* note 83, at 277 *et seq.* For a lesson on the dangers of derivatives when hedging turns into a wrong speculative bet on the direction of the market, see Linda Sandler, *Heard on the Street: Endowments at Top Schools Bruised in Market*, WALL ST. J., Oct. 13, 1998, at C1.

¹⁸⁹*See Note: Tax-Exempt Entities, Notional Principal Contracts, and the Unrelated Business Tax*, 105 Harv. L. Rev. 1265 (1992). In a swap, for example, the "notional principal" is the amount of principal on which the swap payments are calculated. The principal is "notional" because it never actually changes hands.

amount of the payments calculated with reference to a specified index and based on a notional principal amount. As notional principal contracts proliferated and found their way into portfolio management techniques employed by tax-exempt investors, understandable concerns arose over how they would be taxed under a UBIT regime that never contemplated their existence. The major uncertainties were: (1) do receipts from notional principal contracts constitute income from a trade or business, as that term is construed for UBIT purposes?; (2) if the answer to (1) is yes, do the receipts nonetheless fit within any of the § 512(b) exclusions for passive investment income (a seeming contradiction for anyone who thinks there is a bright line dividing active business and passive investment activities)?; and (3) in any event, do these transactions generate UBTI under the unrelated debt-financed rules in § 514 because they involve a form of leverage?

Informed commentary on these questions revealed the answers were not simple. Consider an interest rate swap, which is a contract between two investors for the exchange of periodic interest payments for a fixed period of time based upon an agreed principal amount. Some argued that receipts from interest rate swaps were a form of ordinary financial services income, or income from self-insurance.¹⁹⁰ Most agreed that, technically speaking, receipts from interest rate swaps were not "interest" because they were not compensation for the use or forbearance of money. Similarly, receipts from equity index swaps were not "dividends," and income from currency swaps were neither interest nor dividends.

Once again, though, never mind! The Service, recognizing that the § 512(b)

exclusions should be interpreted with sufficient flexibility to embrace new financial products that had become staples of institutional portfolio risk management, issued regulations providing that income from notional principal contracts and "other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner" are not includible in UBTI.¹⁹¹ For this purpose, a "notional principal contract" is "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."¹⁹²

Although the § 512 regulations do not address whether the "implicit leverage" in notional principal contracts triggers "acquisition indebtedness" under § 514(c) and thus raises the specter of taxable income from debt-financed property, the Service's treatment of other risk management and return enhancement strategies strongly suggests that § 514 is not a serious threat if no "explicit leverage" is employed.

5. Private Equity Investments

The private equity niche consists primarily of venture capital, workout and

¹⁹⁰Note, *supra* note 189, at 1276.

¹⁹¹Treas. Reg. § 1.512(b)-1(a)(1). Similar reasoning has been applied to commodity futures transactions. See P.L.R. 80-44-023 (Aug. 5, 1980), where the Service ruled that the obligations under commodity futures contracts did not amount to indebtedness because of the executory nature of the contract. See also T. A. M. 96-42-041 (July 22, 1996), relating to stock index arbitrage transactions; G.C.M. 39,615 (Mar. 23, 1987).

¹⁹²Treas. Reg. § 1.863-7(a)(1), cross-referenced in Treas. Reg. § 1.512(b)-1(a)(1). See also Reg. § 1.446-3(c)(1).

leveraged buyout funds, and investments in natural resources such as oil and gas.¹⁹³ Private equity investments ordinarily are illiquid assets with a time horizon well beyond one year. Most are made through pools structured as limited partnerships or limited liability companies. A few universities have established their own venture capital funds -- e.g., Vanderbilt's Chancellor Fund invests in start-ups linked to the institution, such as companies formed around a discovery or business concept based on the university's research.¹⁹⁴ Assuming, as is the norm, that the pool makes its venture capital and LBO investments in private companies formed from the outset as C corporations, the principal tax items are dividends (rare), interest (on cash reserves or debt instruments), capital gains (by far the main event), and occasionally reduced management fees otherwise payable to the for-profit general partner of the pool resulting from its receipt of "break-up" fees on deals negotiated but not consummated. Private equity investments (apart from real estate) rarely involve leverage at the investment pool level -- i.e., the venture capital or LBO fund will not incur debt to acquire the private companies in its portfolio -- but occasionally some bridge financing may be necessary if cash calls to the partners lag behind the pool's time-sensitive commitments.

To date, private equity investments have raised relatively few serious UBIT issues. Interest, dividends, mineral royalties (other than income from working interests), and capital gains passing through to tax-exempt partners are excluded under § 512(b). UBTI is likely to result only if break-up fees are received and somehow are allocated to the

¹⁹³Some also would include real estate in this category. For discussion of the tax aspects of real estate investments, *see infra* notes 206-228 and accompanying text.

limited partners, bridge financing causes some income to be debt-financed, or when the fund invests in start-up companies formed as pass-through entities for tax purposes, causing their business activities and tax items to be attributed through the fund to its partners.¹⁹⁵ Since start-up companies rarely generate any taxable operating income before (or even after) they go public, any actual UBIT exposure is likely to be minimal even in those cases.

If a private equity fund expects to generate some UBIT, tax-exempt investors must simply take the tax liability into account in evaluating their return. Considering the proven upside potential of private equity, any tax liability should be just a minor depressant. Anecdotal evidence suggests, however, that some tax-exempt investors regard the UBIT as a communicable disease to be avoided, causing them to invest through "blocker" corporations that, in the end, may not be much more tax efficient than investing directly,¹⁹⁶ or by insisting on provisions in partnership agreements that would insulate them from any UBTI if it should unexpectedly arise.¹⁹⁷ Charitable remainder trusts, of course, regard the UBIT as equivalent to the plague and must avoid any holdings that generate any UBTI or else lose their tax-exempt status.¹⁹⁸

¹⁹⁴See Paul Desruisseaux, *A \$10 Million Fund at Vanderbilt Seeks to Build New Companies*, CHRON. HIGHER EDUCATION, May 26, 2000, at A45.

¹⁹⁵I.R.C. § 512(c).

¹⁹⁶See *Transcript of Winter ABA Tax Section Exempt Organizations Committee Meeting: Panel Eight: Tax Implications of Non-Traditional Investments by Sophisticated Exempt Organizations* (remarks of Brett Robbins, Esq.), 7 EXEMPT ORG. TAX REV. 579, 581-583 (April 1993).

¹⁹⁷Query whether the economic effect of such an allocation would be substantial?

¹⁹⁸See *infra* notes 296-301 and accompanying text.

5. UBIT Avoidance Through Offshore Structures

Although most forms of income from securities and related investments are excludable, some UBIT exposure is unavoidable for hedge funds that engage in absolute return strategies employing leverage. Because most hedge funds are structured and taxed as partnerships, the tax character of any resulting debt-financed income will pass through to tax-exempt partners and be included in UBTI. To avoid these unpleasant consequences, tax-exempt investors -- principally foundations, university endowments, and pension funds -- often invest through an offshore corporation or a parallel hedge fund formed in a favorable tax haven jurisdiction. These structures are widely used by money managers to attract the vast sums of investment capital from the tax-exempt sector.¹⁹⁹

The following classroom hypothetical problem (with accompanying teacher's manual suggested answer) illustrates the convoluted maneuvering required to permit legitimate investment transactions to avoid the UBIT:

Money Manager operates a hedge fund ("Fund") to engage in various absolute return strategies for tax-exempt investors through limited partnerships organized in the United States. Fund is incorporated as a Cayman Island Exempted Company, but all investment activity is managed from Manager's New York office. The sole purpose for incorporating offshore is to minimize any U.S. federal income tax imposed on Fund's income from debt-financed investments. Fund does not invest in real estate, and none of the investors incurred any debt to acquire their interests in Fund. Discuss the tax issues raised by this structure.

A cursory review of the "tax aspects" discussion of our hypothetical Fund's offering prospectus would be enough to send many nonprofit investment committees sprinting

¹⁹⁹See generally Byungkwon Lim, Huey-Fun Lee, Adele M. Karig & Jonathan Boyarin, *Certain U.S. Tax Considerations for Organizing U.S. Hedge Funds*, in TAX PLANNING FOR DOMESTIC & FOREIGN

back to their blue chip portfolios. The tax consequences can be summarized as follows, relegating a few nuances to the footnotes:

- (1) *Taxation of the Fund as a Corporate Entity.* Fund will be classified as a foreign corporation for U.S. tax purposes. As such, it will be taxable at U.S. corporate rates on any income "effectively connected" with a U.S. trade or business that it carries on, and at a 30% rate on certain types of investment income not effectively connected with a U.S. trade or business. Fund will not be considered as deriving any "effectively connected" income because it is not a dealer in stock or securities and because trading activities for its own account (including commodities and probably derivatives) are statutorily excluded from U.S. trade or business status.²⁰⁰ Fund will not be treated as engaged in a U.S. trade or business even though its day-to-day trading is managed from an office within the United States.²⁰¹ Although Fund may derive a small amount of dividend and interest income that will be subject to U.S. tax through withholding at the flat 30% rate, the bulk of its portfolio interest (including original issue discount), capital gains, and other forms of investment income will not be subject to U.S. tax.²⁰² These results are likely but not assured. Uncertainties relate to whether the Fund itself will be treated as engaged in a trade or business as a result of its own activities or of any of the partnerships in which it invests.²⁰³
- (2) *Cayman Islands Taxation of the Fund.* No tax.
- (3) *U.S. Taxation of the Tax-Exempt Investors.* Because Fund is a corporation, the character of any debt-financed income that it may realize will not pass through to its tax-exempt "shareholders." Fund likely will constitute a passive foreign investment company ("PFIC") under § 1297, but proposed regulations provide that if a shareholder of a PFIC is an exempt

PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES (Practising Law Institute Course Handbook, 2000).

²⁰⁰I.R.C. § 864((b)(2).

²⁰¹Prior to 1997, this was not necessarily assured. Under prior law, to be considered as having its principal office outside the United States, an offshore fund was required to conduct a substantial portion of ten activities outside the country. These "Ten Commandments" related to largely ministerial duties (e.g., communicating with shareholders, maintaining principal records, making disbursements, conducting meetings). See Treas. Reg. § 1.864-2(c)(ii) & (iii) (applicable to tax years beginning on or before December 31, 1997). It is understood that some offshore funds still enjoy holding periodic meetings if their corporate domicile is in a warm winter climate.

²⁰²For some background, see *supra* notes 66-73 and accompanying text.

²⁰³It also should be assumed that Fund does not invest in U.S. real estate or pass-through entities (e.g., REITs) holding real estate. In that event, additional issues, implicating the taxation of foreign investors on U.S. real estate holdings (e.g., FIRPTA) would be raised. See I.R.C. § 879.

organization, the special PFIC taxing regime (don't ask) would apply only if a dividend would be UBTI, which it normally would not be.²⁰⁴ Although unlikely, it is possible, if ownership is concentrated in a few investors, that Fund will constitute a controlled foreign corporation -- i.e., a foreign corporation where "10% U.S. shareholders" in the aggregate own more than 50% of the voting power or value of the outstanding stock. If Fund is a CFC, any 10% U.S. shareholder's (directly or through constructive ownership rules) pro rata share of Fund's Subpart F income will not constitute UBTI except for income from certain insurance activities in which Fund is unlikely to engage. Otherwise, distributions received by tax-exempt investors from Fund will be excluded from UBTI as dividends.

If there were any doubt about the viability of offshore structures (and there wasn't, really, among investment industry insiders), it was dispelled by the quiet appearance in 1999 of a letter ruling²⁰⁵ confirming that the roundabout approach to UBIT avoidance even was available to charitable remainder trusts, the most UBIT-averse resident of the nonprofit sector. One can only assume that the charitable remainder unitrust (CRUT) requesting the ruling was enormous and pursuing a diversified asset allocation discipline that included investments in U.S. hedge funds utilizing leverage. The CRUT's solution was to form and fund a wholly owned corporation ("Blocker Sub") in a zero tax foreign jurisdiction ("Tax Haven") to limit liability, provide "flexibility" in disposing of partnership interests, manage additional investments the CRUT might wish to make, and (the punch line) avoid UBIT. Blocker Sub proceeded to invest (along with other unrelated parties) in a U.S. partnership ("Fund") that, according to the ruling, expected to earn some debt-financed income from leveraged investments. The distributive share of tax items from Fund initially passed through to Blocker Sub and, at some point, Blocker Sub would

²⁰⁴Prop. Reg. § 1.1291-1(e).

²⁰⁵P.L.R. 1999-52-086 (Sept. 30, 1999). For an analysis of the ruling, see Catherine E. Livingston, *Letter*

receive distributions from Fund and then make distributions to its parent CRUT.

The ruling is consistent with the analysis of our classroom hypothetical but goes beyond that fact pattern in that the U.S. tax-exempt investor was the sole shareholder of the foreign corporation. Its essential conclusions were:

- (1) Blocker Sub was a controlled foreign corporation, and CRUT was a U.S. shareholder which, if it were not tax-exempt, would be taxable on the CFC's Subpart F income, which included (among other things) various forms of passive investment income, whether or not received by the CRUT.
- (2) Except for the narrow but nettlesome category of Subpart F insurance income, CRUT's share of Subpart F income was analogous to a dividend and thus would not be included in UBTI. This was the case with respect to Blocker Sub's distributive share of Fund's income, and to amounts actually distributed by Fund to Blocker Sub, and by Blocker Sub to CRUT.

The message is that form matters. The policy question is whether the indirect route illustrated by offshore blocker strategy should itself be blocked, or whether the rules that caused the route to be taken should be modified.

7. Summary and Conclusions

Although it took some prodding, the Service's response to the evolving nonprofit investment environment has been constructive and faithful to the policy of excluding passive investment income from UBTI. The positions taken on securities lending, short

Ruling Alert, 27 EXEMPT ORG. TAX REV. 263 (Feb. 2000).

sales, options, swaps, and most other derivatives have the effect of narrowing the reach of the debt-financed property rules, and they go far to immunize valid hedging strategies from tax. The lingering problem, if there is one, is that definitive guidance on the UBIT consequences of emerging risk management transactions is often slow in coming -- understandably, considering the hyperactivity of the financial services industry in marketing new products.

The investment managers interviewed for this paper do not seem overly preoccupied or unsettled by the lack of guidance, perhaps because it is so unlikely that the Service ever would discover the problem or because they invest through offshore hedge funds and other "blocker" vehicles that avoid the UBIT even where the debt-financed rules would apply if the same investment were made directly. Any hand wringing seems limited to conscientious and cautious tax advisers who are uncertain if a "similar forms of investment income" penumbra has formed around § 512(b) and would prefer a tidier set of rules or, better still, a narrowing or repeal of § 514.

F. Real Estate Activities

1. Introduction

For UBIT purposes, tax-exempt organizations deriving income from real estate holdings are considered passive investors if they limit their level of activity to not much more than collecting rent and avoid debt-financing. Whether or not they are competing with for-profit landlords is irrelevant. This longstanding largesse appears to be based on the assumption that real property rents traditionally have been regarded as a proper

source of revenue not requiring much activity and thus not diverting attention from a charity's exempt mission. For some real estate activities, these assumptions are plainly wrong, but no serious effort has been mounted to roll back the rent exclusion.

2. Rent Exclusion: Unleveraged Real Estate

Because renting even a single piece of real estate is likely to be a trade or business under general tax principles, qualifying for the rent exclusion is critical for exempt organizations seeking to avoid UBTI. Rents from real property are excludable in full, even if they are derived from an actively managed real estate rental "business."²⁰⁶ Personal property rents (e.g., from a lease of computer or medical equipment) are excludable only if derived from a mixed lease and the rents attributable to the personal property are an "incidental" (not more than 10 percent) part of the total rents received under the lease.²⁰⁷ To prevent an obvious end-run around these requirements, multiple leases (i.e., separate leases with respect to real and personal property) are considered as one lease if the real and personal property covered by the lease have an "integrated use."²⁰⁸

Rents dependent on profits or income derived by any person from the real property do not qualify for the exclusion unless they are based on a fixed percentage of gross

²⁰⁶I.R.C. § 512(b)(3)(A)(i).

²⁰⁷I.R.C. § 512(b)(3)(A)(ii); Treas. Reg. § 1.512(b)-1(c)(2)(i). If the amount attributable to personal property is more than incidental but not more than 50% of the total, the real property rent is excludable but the personal property rent is not. But if the personal property rent exceeds 50% of the total, then none of the rent is excludable. I.R.C. § 512(b)(3)(B)(i); Treas. Reg. § 1.512(b)-1(c)(2)(iii)(a). In making these determinations, the terms of the lease are not necessarily conclusive if the amounts allocated are unrealistic. *See* Treas. Reg. § 1.512(b)-1(c)(2)(iv) Example.

²⁰⁸Treas. Reg. § 1.512(b)-1(c)(3)(iii).

receipts or sales.²⁰⁹ The concept here appears to be that if rents are based on the lessee's net income, the lessor is transformed into the lessee's partner rather than a passive rent-collecting landlord.

Amounts paid for the occupancy of space do not qualify for the rent exclusion if the property owner renders services for the convenience of the occupant, as in a hotel, boarding house, parking lot, or warehouse.²¹⁰ Services are considered rendered to the occupant if they are "primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only."²¹¹ Typical controversies involve rental income "kickers" based on a fixed percentage of some profit benchmark (a joint venture?), and services provided in connection with parking lots,²¹² residential rental property,²¹³ facility rentals,²¹⁴ and the like. Because of the myriad variations in commercial lease transactions, the tax analysis can become quite

²⁰⁹I.R.C. § 512(b)(3)(B)(ii). Similar provisions are contained in the rules governing REITs, which must derive a certain percentage of their gross income from "rents from real property." See I.R.C. §§ 856(c)(2), (c)(3)(A); 857(d)(2)(A). The REIT regulations are a source of guidance for purposes of the UBIT rent exclusion. See Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b), incorporating by reference Treas. Reg. §§ 1.856-4(b)(3) & (6).

²¹⁰Treas. Reg. § 1.512(b)-1(c)(5).

²¹¹*Id.*

²¹²See, e.g., G.C.M. 39,825 (Aug. 17, 1990) (receipt of revenue from direct operation of commercial parking lot was UBTI, not excludable rent, but revenue from net leasing the entire parking lot to a third party was excluded as rent if the organization did not provide services in connection with the lease). Revenue from a parking lot that serves students, patients, faculty, and staff of a school or hospital comfortably fits within the § 513(a)(2) convenience exception even if services are provided. See Rev. Rul. 69-269, 1969-1 C.B. 160.

²¹³See, e.g., P.L.R. 98-50-009 (Sept. 9, 1998), outlining permissible and impermissible services.

²¹⁴See, e.g., P.L.R. 97-02-003 (Aug. 28, 1996) (museum's rental of its facilities for corporate events was not eligible for rental exclusion because museum provided significant services, such as use of liquor license and use of personnel to set up and operate equipment); *Madden v. Commissioner*, 74 T.C.M. (CCH) 440 (1997) (outdoor art museum at large office complex not taxable on revenue received for leasing space for special events because making space and art available to public was substantially related to exempt purposes; but revenue from lease of amphitheater was taxable because activity was profit motivated and rent was based in part on percentage of lessee's profits).

complex. Consider, for example, an exempt organization that leases real property (e.g., a shopping center) to a Prime Tenant, which then subleases space to various Occupancy Tenants under leases that typically provide a fixed minimum rent and additional percentage rent based on sales, with a variety of exclusions and adjustments. These rental formulas require scrupulous attention to detail to avoid a disqualifying percentage-of-net-income arrangement.²¹⁵ Astute planning also may ensure that excludable rents are not converted into taxable UBTI because the exempt organizations renders significant services. For example, the Service has ruled that operation of a commercial parking facility rarely produces "rent," even in the absence of valet service, but rent from the lease of a parking lot to an unrelated third party will be excludable if the arrangement is not a joint venture.²¹⁶

2. Debt-Financed Real Estate

Debt-financed real estate is the principal target of § 514.²¹⁷ Where debt is incurred to acquire or improve income-producing property the use of which is not substantially related to the exercise or performance of the organization's exempt purposes, a portion of

²¹⁵For those who wish to delve into this splendid minutia, *see* Lewis R. Kaster, *Real Estate Transactions by Tax-Exempt Entities*, TAX MGMT. PORTFOLIO 591 (1999). The REIT area also offers guidance. *See, e.g.*, Treas. Reg. § 1.856-4(b)(6)(i), providing that if a tax-exempt organization leases real property to a prime tenant with rent based a percentage of gross receipts and the prime tenant subleases all or part of the property for rent based wholly or partially on the net profit or income of the subtenant, the entire amount received from the Prime Tenant is taxable.

²¹⁶*See, e.g.*, G.C.M 39,825 (Aug. 27, 1990); P.L.R 97-51-036 (Sept. 23, 1997) (interpreting "rents from real property" for purposes of the analogous REIT rules in § 856(d)).

²¹⁷*See supra* notes 168-171 and accompanying text for a description of the basic operation of § 514.

the otherwise excludable rental income will be included in UBTI.²¹⁸

Section 514(c)(9) contains an important exception for indebtedness incurred with respect to real estate held by qualified pension and profit sharing trusts, educational organizations described in § 170(b)(1)(A)(ii) and their affiliated support organizations described in § 509(a)(3), and § 501(c)(25) holding companies.²¹⁹ In general, debt incurred directly by these "qualified organizations" to acquire or improve any real property is not "acquisition indebtedness" if:²²⁰

- (1) The acquisition price is a fixed amount determined as of the date of the acquisition or completion of the improvement;
- (2) The amount of the debt, or the time for making payment, is not dependent on profits derived from the property;
- (3) The property is not leased back to the seller or to any person related to the seller within certain statutory attribution rules;
- (4) In the case of a qualified pension or profit sharing trust, the property is not acquired from or leased back to certain "disqualified persons," as defined in § 4975(e)(2);
- (5) Neither the seller, a party related to the seller, nor a disqualified person

²¹⁸I.R.C. § 514(b)(1)(A)(i). Exceptions are provided for encumbered property received by gift or bequest, or certain acquisitions of income-producing real estate where the organization intends to demolish the improvements and convert the property to exempt use within five to ten years. See I.R.C. §§ 514(c)(2)(B) (gifts and bequests); 514(b)(3) ("neighborhood land" rule).

²¹⁹Section 501(c)(25) title holding companies pass through their income to their shareholders or beneficiaries. These beneficial owners may utilize the § 514(c)(9) exception with respect to amounts passed through to them only if they are qualified pension trusts, or the types of educational organizations described in § 170(b)(1)(A)(ii). I.R.C. § 514(c)(9)(F).

²²⁰I.R.C. § 514(c)(9)(B)(i)-(v).

provides financing in connection with the acquisition or improvement.

It has been suggested that the only reason why the § 514(c)(9) exemption was enacted is that "some people wanted it" in order to achieve greater investment diversification for the nonprofit organizations that they represented!²²¹ The exception initially was available only to qualified pension trusts; their lobbyists argued that they were at a competitive disadvantage relative to banks and insurance companies. Then more people wanted it. Over the Treasury's objection, § 514(c)(9) was extended in 1984 to schools, colleges and universities, and in 1986 to certain real estate title holding companies. Private foundations and hospitals would like to be added to this charmed circle, and it is difficult to articulate any coherent policy for denying access to them or any § 501(c)(3) organization for that matter now that the exemption is available beyond the pension community.

4. Real Estate Partnership Investments

Charitable endowments and pension funds often make real estate investments through limited partnerships or LLCs. Because these partnerships commonly employ leverage, § 514 lurks as a UBIT spoiler, but relief is provided if the partnership meets the five § 514(c)(9) requirements set forth above and, in addition, either: (1) all the partners are "qualified organizations" (rare, since real estate partnerships almost always are sponsored by a taxable general partner and include taxable investors as limited partners),

²²¹BITTKER & LOKKEN, *supra* note 10, ¶ 103.4.3.

(2) each allocation to a qualified organization is a "qualified allocation,"²²² or (3) in the case of disproportionate allocations, the partnership agreement complies with a mind boggling web of rules designed to prevent abusive income-shifting between exempt organizations and their taxable partners.²²³

For virtually all real estate investment partnerships having both tax-exempt and for-profit partners, the disproportionate allocation rule in § 514(c)(9)(E) is the main event. To characterize this rule as a "trouble spot" is perhaps too charitable. It is more accurately described by any number of adjectives, ranging from the relatively benign ("challenging") to the pejorative ("hypertechnical," "inexplicable," "illusory" and "draconian" are within the acceptable range).²²⁴ To satisfy § 514(c)(9)(E), two broad requirements must be met: (1) the allocation of items to any qualified organization partner must not result in QO having a share of overall partnership income for any taxable year that is greater than the partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest (known as the "Fractions Rule"), and (2) each partnership allocation must have "substantial economic effect" within the meaning

²²²Generally, a "qualified allocation" is one that (1) is consistent with the exempt organization being allocated the same distribute share of all tax items during the entire period the organization is a partner, (2) has substantial economic effect within the meaning of § 704(b)(2). See I.R.C. § 168(h)(6). Few real estate investment partnerships can comply with this requirement because the normal economic deal, with its preferred return to the investors and performance allocations to the general partner precludes the lock-step type of allocation required by the statute.

²²³I.R.C. § 514(c)(9)(B)(vi).

²²⁴See, e.g., William B. Holloway, Jr., *Structuring Real Estate Investment Partnerships With Tax-Exempt Investors*, 87 TAX NOTES 1517 (June 12, 2000); WILLIAM S. MCKEE, WILLIAM L. NELSON & ROBERT L. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 9.03[3][c] (3d ed. 1996). With atypical overstatement, the New York State Bar Association has opined "that no provision of the tax law is more conceptually and technically flawed, more difficult and vexing to deal with, and more wasteful of taxpayer and governmental resources than section 514(c)(9)(E)." New York State Bar Association Tax Section, *Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and*

of § 704(b)(2) as amplified by the regulations.²²⁵ Practitioners with experience in this area will testify that, despite detailed regulations first issued by the Service in 1993, these "deceptively simple" rules present a "formidable challenge to all who struggle with them, even in the simplest of cases."²²⁶

Any discussion of what is right and wrong about the disproportionate allocation rules requires an intimate understanding of complex real estate partnership agreements and partnership tax. Despite the author's meaningful long-term relationship with Subchapter K,²²⁷ he recognizes that partnership tax is an acquired taste to be shared only on special occasions. On the convenient assumption that this otherwise admirable conference is not such an event, it is sufficient to conclude this section with a few generalizations:

- (1) Since the Fractions Rule must be satisfied prospectively as well as actually for each year, a potential future violation will cause the partnership to fail the test for all taxable years, even those preceding the year of the violation. Practitioners complain that it is impossible to anticipate very conceivable allocation that may occur in the future.
- (2) Even de minimis violations taint the entire investment. This "cliff effect" causes all debt-financed income earned by QOs to be UBTI (in the appropriate percentage) even where the foot fault is not abusive.

Other Qualified Organizations (Feb. 14, 1997), available at 97 TNT 34-39.

²²⁵See Treas. Reg. § 1.704-1(b)(2).

²²⁶Holloway, *supra* note 224, at 1520.

²²⁷See STEPHEN A. LIND, STEPHEN SCHWARZ, DANIEL J. LATHROPE & JOSHUA D. ROSENBERG, *FUNDAMENTALS OF PARTNERSHIP TAXATION* (5th ed. 1998).

- (3) The rules are complex and mechanical, making it difficult to accomplish customary, nonabusive objectives.

Like the collapsible corporations rules and the alternative minimum tax, the Fractions Rule is a candidate for repeal. The American Bar Association's Section on Taxation has included § 514(c)(9)(E) on its complexity hit list in a recent submission to Congress on tax simplification.²²⁸ More general provisions of Subchapter K, such as the substantial economic effect requirement in § 704(b), should be adequate to prevent abusive allocations without impeding legitimate economic relationships between taxable and tax-exempt investors.

G. Exploitation of Intellectual Property: The Royalty Exclusion

The § 512(b)(2) royalty exclusion extends to "all royalties . . . whether measured by production or by gross or taxable income from the property," less directly connected deductions.²²⁹ The Code does not define "royalty" for UBIT purposes, and the legislative history is silent as to why royalties were included in the list of passive investment income items. Presumably, Congress concluded that mineral royalties and revenue from licensing various forms of intellectual property were among the proper passive sources of support. As it has been interpreted, the royalty exclusion extends to virtually all payments for the right to use intangible property, including income received for the use of valuable

²²⁸*American Bar Association Section on Taxation, Testimony of Pamela F. Olson to Subcomm. on Tax, Finance, and Exports, House Small Business Comm., reprinted in 88 TAX NOTES 1531, 1536 (Sept. 18, 2000).*

²²⁹I.R.C. § 512(b)(2).

intellectual property rights, such as patents, trademarks, and copyrights,²³⁰ but not to compensation for services rendered by the owner of the licensed property.²³¹ Because the royalty concept is so elastic, exempt organizations frequently enter into licensing arrangements to exploit their valuable forms of intangible property rather than developing them directly.²³²

A long expressed concern is that the royalty exclusion permits exempt organizations to share revenue from an active business activity while escaping the UBIT. Examples abound, ranging from the licensing of Big Bird and other popular Sesame Street characters by the Children's Television Workshop, to logos on apparel, coffee mugs and credit cards, to the use of an organization's reputation for endorsement of commercial products. The vast majority of licensing arrangements do not require the exempt organization to devote much of its time to the enterprise. Manufacturing, marketing, distribution, and all the "active" elements of a trade or business are handled by the for-profit licensee. The Service permits nonprofit tax-exempt licensors to retain quality control, and royalty payments may be based on a percentage of gross sales, but the line is crossed if the exempt organization becomes actively involved in the development and marketing of the product.²³³

A recent letter ruling (reportedly involving the American Association of Retired

²³⁰Treas. Reg. § 1.512(b)-1(b).

²³¹See, e.g., *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996) and *supra* notes 147-149 and accompanying text.

²³²The same might be said about the broad exclusions for research income in §§ 512(b)(7)-(9), which are beyond the scope of this paper because they reside more at the border of "related" vs. "unrelated" than "business" vs. "investment." These exclusions have been largely ignored in most UBIT scholarship and would benefit from closer scrutiny.

Persons) illustrates that even where an exempt organization performs significant services in connection with a licensing arrangement, its UBIT exposure can be minimized by using a taxable subsidiary to perform the services.²³⁴ In the ruling, the parent § 501(c)(4) organization ("AARP") was engaged in extensive licensing activities. It created a for-profit subsidiary to which it transferred its mailing list (for no fee), employees and other resources. AARP retained for itself the royalty income stream paid by third-party licensees, while the taxable subsidiary received fees for services, undoubtedly minimizing its bottom line by deducting related expenses. Because the subsidiary had a bona fide business purpose and a majority of its directors were "independent" of AARP, the parent's role was limited to its capacity as shareholder. As a result, the royalty and services income were successfully separated, preserving the § 512(b) exclusion for the bulk of the income generated from a program that apparently involved considerable business activity by the AARP consolidated group.²³⁵

During the 1987 UBIT hearings, the Treasury characterized many licensing arrangements as akin to joint ventures in an active business. Even more passive deals were seen as tantamount to endorsements of commercial products. Recommendations included a narrower definition of royalty to tax amounts measured by net profits and arrangements where exempt organizations were exploiting goodwill and other intangibles generated by their exempt mission. The House Oversight Subcommittee's draft report concurred except in cases where the arrangement furthered the organization's exempt purposes. The

²³³See, e.g., Rev. Rul. 81-178, 1981-2 C.B. 135.

²³⁴P.L.R. 1999-38-041 (June 28, 1999).

²³⁵By keeping the royalties at the parent level, the arrangement also nicely avoids any problem that would

report specifically stated that licensing a trademark or logo in an attempt to foster name recognition would not, without more, be treated as furthering an exempt function.²³⁶

The charitable sector's hostile reaction was predictable. Their advocates found no sound tax policy reason to penalize a particular form of "passive investment" and crudely analogized royalties to dividends. The royalty exclusion was defended as a sound way to encourage exempt organizations to leave active management of income-producing businesses to for-profit taxpayers.²³⁷ Where the exempt organization actively participated in production, distribution, marketing or sale, however, a clearer standard for differentiating active from passive businesses was the suggested solution.²³⁸

"Commentators" (mostly practitioners with adversely affected clients) argued that "passive" licensing arrangements presented no threat of unfair competition and warned that taxing royalties would be a radical departure from the longstanding policy of exempting revenue from passive sources. They noted, with some persuasive force, that the effort to tax royalties was motivated more by a subjective sense that some arrangements were inappropriate or "unseemly" and defended royalty arrangements as a means to foster greater name recognition for the charity.²³⁹

If Congress intended the § 512(b) "modifications" to exempt passive *investment* income, the expansive definition of "royalty" under current law seems incompatible with

have been presented under § 512(b)(13) if the controlled subsidiary had paid royalties to the parent.

²³⁶Subcomm. on Oversight of House Ways and Means Comm., *Draft Report Describing Recommendations on the Unrelated Business Income Tax*, 100th Cong., 2d Sess. 52 (Comm. Print 1988) [hereinafter "1988 Draft UBIT Report"].

²³⁷1987 UBIT Hearings, *supra* note 127, at 210 (statement of Independent Sector).

²³⁸*Id.*

²³⁹For one of the more thoughtful arguments, see Thomas A. Troyer, *Changing UBIT: Congress in the*

that policy. The House Oversight Committee recognized as much in 1987, but proposals to tighten the royalty exclusion remain on the far back burner, and the Service's track record in litigation does not hold out much hope that the courts will intervene. Although there is no indication that the current state of affairs is creating any competitive imbalance problem, nobody knows for sure in the absence of an authoritative empirical study. Like some corporate sponsorships, royalty and endorsement deals are seen by some as unseemly and inconsistent with proper charitable behavior. The challenge for those who seek to tax royalties is to articulate a coherent rationale that goes beyond indignation.

IV. TAXING COMPLEX BUSINESS AND INVESTMENT STRUCTURES

A. Conceptual Models

The UBIT's treatment of an exempt organization's participation in the various legal forms available to conduct a business or investment activity is influenced by the conceptual taxing models adopted by the Internal Revenue Code. The three principal business enterprise tax regimes are found in Subchapter K (§§ 701-761, governing partnerships and limited liability companies), Subchapter C (§§ 301-385, governing publicly traded corporations and private companies that are either ineligible to be S corporations or choose not to make an S election), and Subchapter S (§§ 1361-1378, governing eligible closely held companies that make an S election).

In theory, at least, Subchapter C is a double tax regime.²⁴⁰ C corporations are subject to tax on their net income at rates that peak at 35%, and earnings distributed as

Workshop, 41 TAX NOTES 1221, 1225-1226 (Dec. 12, 1988).

²⁴⁰We say, in theory, because legitimate tax preferences (e.g., accelerated depreciation and other beneficial timing provisions) and tax shelters are threatening to erode the corporate income tax base.

dividends (or in certain other dividend-equivalent transactions) are taxable again at the shareholder level. By contrast, Subchapters K and S are pass-through regimes.

Partnerships, limited liability companies, and S corporations (with a few exceptions unimportant for our purposes) are not subject to an entity-level tax. Instead, their income, deductions, and other tax items pass through to the partners, members or shareholders, retaining their unique tax character. Although Subchapters K and S have much in common, they are markedly different in many respects. Among other things, Subchapter K offers far more access and flexibility while Subchapter S has the virtue of relative simplicity. Much could be (and has been) said about the incoherence of the current system but this is not the place to rehash that ongoing dialogue.

With these models lurking in the background, this Part examines the UBIT's treatment of the complex structures currently in vogue.

B. Pass-Through Entities

As illustrated throughout this paper, exempt organizations use partnerships as an investment vehicle, a means for accomplishing exempt purposes, and to engage in active business pursuits, often with for-profit partners. The principal tax issues are the effect of the organization's participation on its qualification for tax-exempt status, and whether any of the organization's share of partnership income is subject to the UBIT. The discussion in this section is generally confined to the UBIT issues. The special problems of joint

ventures are discussed in a later section.²⁴¹

1. Investments in Operating Businesses

Tax-exempt partners of a partnership (or LLC) that is regularly engaged in a trade or business that would be unrelated if carried on directly by the exempt organization are taxable on their distributive share of partnership gross income less directly connected deductions.²⁴² This was always assumed to be the rule where the exempt organization was a *general* partner, but tax-exempt limited partners argued that they were merely passive investors and should not be taxable on the theory that their share of partnership income, whatever its source, was analogous to the types of passive investment income excluded by § 512(b). If accepted, this theory would result in no tax being imposed on income that would have been taxable if the organization had conducted the business directly.

In *Service Bolt & Nut Co. v. Commissioner*,²⁴³ the Tax Court employed an aggregate theory in holding that a tax-exempt limited partner was deemed to be engaged in any unrelated (to the partner) trade or business carried on by a partnership operating an active business. The court concluded that whether the tax-exempt partner actively managed the business was irrelevant to whether the partnership as a whole has an unfair competitive advantage. Query, however, if unfair competition is really the point here. Tax-exempt investors have major holdings in all publicly traded U.S. corporations, but the

²⁴¹See *infra* notes 286-294 and accompanying text.

²⁴²I.R.C. § 512(c)(1). If an exempt organization is a partner in a partnership or LLC that engages in a business that is substantially related to the organization's exempt purposes, it normally would avoid any UBIT exposure. See, e.g.,

²⁴³78 T.C. 812 (1982). See also Rev. Rul. 79-22, 1979-2 C.B. 236.

double tax regime of Subchapter C does not grant an exemption for the portion of business income attributable to their holdings. Leaving aside the question of the appropriate rate, what is at stake here is whether at least one level of tax will be imposed on income from a trade or business. The Tax Court's interpretation of § 512(c) ensures that result, precluding an easy end run around the policy of the UBIT.

2. Investment Partnerships

The vast majority of commingled investment pools in the United States are operated as limited partnerships or LLCs. The specific investment strategies of these funds vary widely, ranging from the classic hedge fund that seeks to minimize risk by holding both long and short market positions, to real estate and venture capital funds, and to more exotic investments in risk and event arbitrage transactions, debt of financially distressed companies, foreign currency, and harvestable timber.

As we have seen, tax-exempt partners may or may not be subject to the UBIT depending on the partnership's activities. If the partnership is an investor (as distinguished from a dealer or a trader), then dividends, interest, capital gains, rents, and royalties are separately stated as such on a tax-exempt partner's Form K-1 and are excluded from UBIT under § 512(b). But subject to the exceptions already discussed, income from debt-financed property is taxable under § 514,²⁴⁴ and gains on any sales of dealer property are taxable. This is a significant problem in any partnership utilizing leverage or acting as a dealer in securities or real estate.

Some investment partnerships, such as hedge funds engaging in arbitrage strategies, consider themselves traders rather than investors, and report their income (which usually consists of a combination of dividends, interest, short-term capital gains, gains from § 1256 regulated futures contracts, and the like) and related expenses as a single item of "nonpassive" business income on Line 1 of each partner's K-1. As discussed earlier,²⁴⁵ taxable partners may benefit from trader status, but ordinarily tax-exempt partners do not suffer. Even though "trading" is a "trade or business" rather than an investment for some purposes,²⁴⁶ most types of income from securities trading fit within the § 512(b) exclusions and thus are not included in UBTI.

The author is aware that a few universities have created their own venture capital funds but has been unable to obtain sufficient specifics on the structure of these funds to analyze their tax consequences with any assurance. To the extent the university, either directly or through a separate affiliated entity, serves as managing general partner, any management fees derived from its efforts are surely from a trade or business and should be included in UBTI. But if the fund is totally in-house, the university need not pay itself any management fee, and it likely would realize its entire return from excludable passive investment sources.

3. Publicly Traded Partnerships

²⁴⁴See Rev. Rul. 74-197, 1974-2 C.B. 143.

²⁴⁵See *supra* notes 47-48 and accompanying text.

²⁴⁶See *supra* notes 44-46 and accompanying text.

Since 1987, most publicly traded partnerships (PTPs) are taxed as C corporations unless they derive 90% or more of their gross income from certain types of passive sources or elected to qualify for transitional relief.²⁴⁷ The theory is that PTPs resemble publicly traded corporations and thus should be subject to the double tax regime of Subchapter C. The exceptions were designed primarily for publicly traded oil and gas ventures that typically had operated as partnerships and a handful of public companies that had chosen the partnership form.

For those PTPs still taxed as partnerships, the concern was whether income allocable to tax-exempt partners would wholly escape any level of tax. Initially, § 512(c) provided that an exempt organization's distributive share of all PTP income less directly connected deductions automatically would be included in UBTI. This rule was modified in 1993, and now a tax-exempt organization owning an interest in a PTP taxed as a partnership must include its share of the PTP's income in UBTI to the extent that it would have been included if it were earned directly by the tax-exempt organization. As a result, any excludable items (e.g., dividends, interest, rents) passing through from a PTP to a tax-exempt partner are not included in UBTI. Although the statute is not crystal clear on this point, § 512(c) should not apply to the few remaining PTPs that are taxed as C corporations because they are subject to the corporate income tax. It follows that distributions from such PTPs should be treated as excludable dividends under

²⁴⁷I.R.C. § 7704(a), (c).

§ 512(b)(1).²⁴⁸

4. Limited Liability Companies: Special Problems

Limited liability companies (LLCs) have been discovered by exempt organizations. LLCs with more than one member are normally taxed as partnerships unless they elect to be treated as an association taxable as a corporation. Single member LLCs also may elect corporate tax status, but if not the default rule treats them as disregarded entities for tax purposes -- i.e., as sole proprietorships, if they have an individual owner, or as divisions if they are wholly owned by an entity such as a corporation.²⁴⁹

Exempt organizations utilizing single member LLCs have concluded that they can be a useful vehicle to hold real estate to shield the parent organization from environmental and other liability exposure. The Service has taken a sensible approach to this phenomenon, treating a wholly owned LLC that does not elect corporate status as a "tax nothing," entitled to exempt status along with its parent and treated as a division of its owner for UBIT and Form 990 filing purposes.²⁵⁰ At this writing, the Service had not yet decided whether a contribution (e.g., of real estate) made directly to a single member LLC would be deductible as a charitable contribution. This question raises some troublesome questions (can an LLC be treated as a "corporation, trust, community chest, fund, or foundation" as required by § 170(c), and what if the LLC does not operate exclusively for

²⁴⁸See Johnny Rex Buckles, *Publicly-Traded Partnerships and Taxable Income*, 53 *Tax Lawyer* 129 (1999).

²⁴⁹See generally *Treas. Reg. § 301.7701-3*.

²⁵⁰I.R.S. Ann. 99-102, 1999-43 I.R.B. 45. See also Internal Revenue Service, *Exempt Organization Continuing Professional Education Technical Instruction Program for FY 2001* [hereinafter "EO CPE 2001"], ch. B, available electronically at 2000 TNT 175-31 (2000).

charitable purposes²⁵¹), but the logic of the disregarded entity theory seems to support a deduction.²⁵¹ If a single member LLC elects corporate tax status, the Service has set forth 12 conditions that must be met to qualify for separate § 501(c)(3) or § 501(c)(4) status.²⁵²

The use of LLCs in joint ventures with for-profit taxpayers is discussed elsewhere in this paper.²⁵³ Suffice it to note here that the major issues presented by such joint ventures are whether they jeopardize the exempt status of their tax-exempt members because of a failure to be operated for charitable purposes or, if not, whether their activities generate UBTI. If an LLC is used for purely investment activities and has multiple members, the excludable character of dividends, interest, capital gains, and rents will pass through as such and not be taxed, absent debt-financing.

5. S Corporations

Effective January 1, 1998, § 401(a) pension trusts and § 501(c)(3) organizations can be shareholders of S corporations²⁵⁴ To ensure that the tax-exempt shareholder's pro rata share of S corporation income does not escape at least one level of tax, a tax-exempt shareholder's share of the S corporation's income, loss, deduction, and other tax items, as well as any gain or loss on a disposition of S corporation stock, is taken into account in computing the exempt organization's UBTI.²⁵⁵ In what appears to be a case of overkill

²⁵¹The I.R.S. has promised to provide guidance on this question.

²⁵²EO CPE FY 2001, *supra* note 250.

²⁵³See *infra* notes 286-294 and accompanying text.

²⁵⁴I.R.C. § 1361(c)(6).

²⁵⁵I.R.C. § 512(e)(1).

relative to the UBIT's treatment of other conduits, taxable pass-through items include dividends, interest, rents, royalties, and capital gains. These passive investment income items would be excluded from UBTI if they were realized through a partnership or LLC. This treatment was justified as appropriate to prevent any transfer of income to non-taxpaying persons and to preserve the relatively simple structure of Subchapter S.²⁵⁶ Since virtually all of these items must be separately determined and reported on the Form K-1 used for all types of pass-through entities, simplicity can't be the reason for this disparate treatment of partnerships and S corporations.

The decision to pass through all S corporation tax items to tax-exempt shareholders raises a host of questions for charities that accept gifts of S corporation stock.²⁵⁷ For example, is municipal bond interest includible in UBTI? (It shouldn't be.) Does S corporation income keep or lose its character as it passes through? (It should, meaning that charitable trusts will get a preferential rate on long-term capital gains, and nonprofit corporations will not.) How do the passive loss limitations apply to a tax-exempt shareholder of an S corporation? These and other fascinating questions and other annoyances have caused many charities to think twice before accepting a gift of S corporation stock, at least if its value or upside is not significant.

6. Summary and Conclusions

Application of an aggregate theory to the activities of a pass-through entity is the

²⁵⁶See S. REP. NO. 281, 104th Cong., 2d Sess. 64 (1996).

²⁵⁷For this list (and more questions and nuances), thanks are due to Professor Christopher Hoyt. See

persistent theme here. As a result, the line drawing issues are no different than if the exempt organization carried on the activities directly. Any other approach would undermine the already limited scope and effectiveness of the UBIT. The treatment of S corporation income as automatically included in UBTI even if derived from passive sources is an aberration but of no great consequence because S corporations are rarely used as vehicles for investment in securities and real estate.

C. Corporate Subsidiaries

1. Typical Settings and Agendas

Exempt organizations often conduct business activities through taxable for-profit subsidiaries. The use of a controlled subsidiary is not motivated solely by tax considerations. The exempt parent may wish to insulate itself from the liabilities of the business; utilize different compensation arrangements, fringe benefit plans or accounting methods; employ different management structures; expand access to investment capital; or avoid public disclosure of business plans and other sensitive financial information.

Tax considerations also play a role. Spinning off what is likely to be a taxable activity into a controlled subsidiary may protect the exempt organization against a challenge to its exempt status. Under current exemption qualification standards, the activities and income of separate controlled entities generally are not taken into account in determining whether an organization's "primary purpose" is an exempt purpose -- at least

Christopher R. Hoyt, *Charitable Gifts of S Corporation Stock: How to Solve the Practical and Legal Problems*, 22 EXEMPT ORG. TAX REV. 25 (1998).

if the parent does not exercise day-to-day operational control over the subsidiary's activities. The separate identity of the controlled subsidiary is almost always respected by the Service, and the ownership of stock of the subsidiary by a public charity is treated as a proper investment activity.²⁵⁸ As a result, exempt organizations can conduct profitable unrelated business activities through subsidiaries without risking their exemption even though their favored tax status might be threatened if they conducted the same activities directly or through a partnership or LLC.²⁵⁹ Taxable subsidiaries also are used to serve as the general partner when an exempt organization engages in a joint venture with for-profit entrepreneurs and investors. The organization might jeopardize its exemption if it served directly as a general partner in certain ventures where the partnership activity does not otherwise further the organization's exempt purposes. A controlled subsidiary also can be effective in reducing the overall tax burden resulting from an unrelated business activity, such as when an exempt organization conducts both an unprofitable "related" activity and a taxable business in a for-profit subsidiary, hoping to use the losses from the related business to offset the profits of the unrelated activity. This type of strategic consolidation could not be accomplished if all the activities were conducted directly by the exempt

²⁵⁸See FRANCES R. HILL & BARBARA L. KIRSCHTEN, FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS, ¶ 9.03 (1994).

²⁵⁹During its scrutiny of the UBIT in the late 1980's, the Oversight Subcommittee of the House Ways and Means Committee made several specific proposals to limit the use of controlled subsidiaries. A particularly controversial recommendation would have required the activities of an exempt parent and its controlled subsidiaries to be treated as an integrated enterprise in determining whether an organization's "primary purpose" was an exempt purpose. See Subcomm. on Oversight of House Ways and Means Comm., *Draft Report Describing Recommendations on the Unrelated Business Income Tax*, 100th Cong., 2d Sess. 63-65 (Comm. Print 1988) [hereinafter "1988 Draft UBIT Report"]. Another interesting approach to the problem would be to extend the private foundation excess business holdings rules to all exempt organizations. See, e.g., Ellen Aprill, *Lessons From the UBIT Debate*, 45 TAX NOTES 1105 (Nov. 27, 1989).

organization.

2. Payments from Controlled Subsidiaries

The proper treatment of payments of passive investment income items received by an exempt organization from a controlled subsidiary has been the subject of considerable debate. To illustrate the possible avoidance agenda, assume that an exempt organization operates an unrelated trade or business through a controlled C corporation subsidiary. The subsidiary wishes to reduce its tax burden; the exempt parent desires a nontaxable return on its "investment" through the receipt of interest, rent and royalties that, unlike dividends, are excludable to the exempt organization but deductible by the for-profit subsidiary. To accomplish these goals, the exempt organization loans money, rents real property, or licenses intellectual property to the subsidiary in exchange for regular payments. Is this an abuse requiring correction, or is it only abusive if and to the extent that the payments exceed the value of the property or services for which the payments are being made? Is it relevant that the exempt organization controls the subsidiary and, if so, what benchmark should be used to measure control?

Since 1969, Congress has viewed the scenario just described as an avoidance opportunity to be policed. Section 512(b)(13) treats what otherwise would be excludable passive investment income as taxable by tracing the payments back to the subsidiary's business operations and treating them as UBTI to the parent to the extent it was sheltered (through deductions) by the subsidiary. Inflated payments were a major concern but a broader theory, it seems, is that payments disguised as passive are in reality attributable to

the unrelated business when made by a taxable subsidiary to its tax-exempt parent. The cure is accomplished by including in UBTI all or part of interest, annuities, royalties and rent received by a "controlling organization" from a "controlled entity".²⁶⁰ In the case of a stock corporation, to which this provision most often applies, "control" is defined as ownership (by vote or value) of more than 50 percent of the stock of the corporation.²⁶¹ Constructive ownership rules, borrowed from the corporate tax world, apply in measuring control.²⁶² Prior to 1997, "control" was determined by an 80 percent benchmark without attribution rules. This loose definition enabled just about any well-advised charity to avoid the impact of § 512(b)(13) by breaking control (easily accomplished) or through crafty devices such as the "double drop down," under which a holding company was placed between the exempt parent and the second-tier taxable subsidiary.²⁶³

When Congress enacted the statutory predecessor of current § 512(b)(13) in 1969, its explanation was brief and cryptic:²⁶⁴

General reasons for change.--Some exempt organizations "rent" their physical plant to a wholly owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables the taxable corporation to escape nearly all of its income taxes because of the large "rent" deduction. While courts have occasionally disallowed some, or all, of the rent deductions, the issue is a difficult one for the Internal Revenue Service.

This language could be interpreted to suggest a narrow concern over inflated payments of

²⁶⁰I.R.C. § 512(b)(13)(C).

²⁶¹I.R.C. § 512(b)(13)(D)(i)(I). For the definition of "control" in other settings, *see* I.R.C. § 512(b)(13)(D)(i)(II), (III).

²⁶²I.R.C. § 512(b)(13)(D)(ii).

²⁶³*See, e.g.* P.L.R 93-38-003 (June 18, 1993).

²⁶⁴STAFF OF JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 91st Cong., 2d Sess. 71 (1970).

rent based on net profits made between related parties not dealing at arm's length. The statute, however, is much broader and is not limited to inflated payments. When Congress amended § 512(b)(13) in 1997, the Joint Committee on Taxation staff defended this breadth by inserting the following additional rationale in its general explanation:²⁶⁵

[E]ven if such payments [from a taxable subsidiary to tax-exempt parent] arguably could satisfy an arm's-length standard, section 512(b)(13) is intended to prevent a tax-exempt parent from obtaining what is, in effect, a tax-free return on capital invested in its subsidiary.

During the 1987 UBIT hearings, when the Treasury first urged Congress to lower the § 512(b)(13) control threshold from 80% to 50% and add attribution rules, many witnesses had no opinion on the proposal. A few supported the Treasury's approach, but some had qualms. A sampling of testimony from the best and brightest provides an interesting historical backdrop to the current debate over the proper scope of § 512(b)(13):

Independent Sector supported tightening the definition of "controlled subsidiary."²⁶⁶

The American Council on Education testified that tightening the control test and adding attribution rules were "reasonable measures to address what we agree has been a problem in this area."²⁶⁷

Professor William T. Hutton observed that § 512(b)(13) had been "enacted in some haste and with insufficient attention to technical details." The definition of "control" was simply imported from the corporate tax provisions, and was "very easy to avoid." His conclusion: "I think the Treasury's suggestion is entirely salutary."²⁶⁸

²⁶⁵STAFF OF JOINT COMMITTEE ON TAXATION, 105th Cong., 1st Sess., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, 239 (1997).

²⁶⁶1987 UBIT Hearings, *supra* note 127, at 207-208.

²⁶⁷*Id.* at 443.

²⁶⁸*Id.* at 734.

Professor Harvey Dale, not surprisingly, testified that "[t]he controlled-subsidary issue is funny." He observed that "[i]f the tax-exempt organization had done the business directly, the profit would have been subject to UBIT. By licensing its wholly owned subsidiary, it can draw out of that subsidiary, through royalties, at least a very significant portion of the income that is deductible to the subsidiary and, therefore, not taxed there, and exempt from UBIT in the hands of the charity and, therefore, not subject to tax there." Professor Dale went on to question the relevance of "control," unless the concern was pricing, noting that otherwise a patent, or real estate, could be licensed or leased to an independent person who would make payments that were excludable to the exempt organization but tax-deductible by the payor.²⁶⁹

Practitioner *James Hasson*, on the same panel with Professor Dale, testified that "[t]he Treasury's diagnosis does not match its prescription" and suggested that while the definition of 80% control might be tightened to prevent abuse, there was no need to reduce the percentage from 80 to 50%. He expressed no reservations about the basic concept of § 512(b)(13).²⁷⁰

The *ABA Tax Section Committee on Exempt Organizations*, in comments submitted several years after the hearings, suggested that a "commercial reasonableness" standard using existing principles under § 482 (authorizing the Service to reallocate income, deductions and other tax items between or among commonly controlled taxpayers) was a more effective cure than the "bright line" test of § 512(b)(13). It agreed, however, that if the bright line approach were the desired solution, tightening the control test and adding narrowly tailored attribution rules were necessary to ensure that the rule was effective.²⁷¹

When Congress finally did put some muscle into the control rules in 1997, tax advisors to adversely affected organizations emerged from their previously secure bunkers to question the fundamental premise of § 512(b)(13). They argued that the longstanding anti-abuse rule tries "to kill an ant with a sledgehammer" and violates rather than enforces basic tax principles.²⁷² Under this theory, the only problem is when the subsidiary pays an

²⁶⁹*Id.* at 1872.

²⁷⁰*Id.* at 1872-1873.

²⁷¹AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, *Comments Concerning Possible Legislative Changes to the Unrelated Business Income Tax Provisions* 39-45 (March 13, 1990) (on file with author).

²⁷²See, e.g., Fred Stokeld, *EO Specialists Have Doubts About Section 512(b)(13) Modification*, 17 EXEMPT ORG. TAX REV. 246, 247 (Aug. 1997).

inflated price to the parent for property or services. So viewed, the cure goes well beyond the abuse, and the proper remedy is to replace § 512(b)(13) with an arm's length standard along the lines of § 482, which polices abusive transactions between commonly controlled taxpayers in the for-profit sector.²⁷³

A simple and superficially appealing example illustrates the opposition's point. Assume an exempt organization ("P") has a wholly owned subsidiary ("S") that engages in an unrelated business. P owns a building that is available for rental as office space. If P leases the space to S at market rates, S can deduct the rent which is then taxable to P under § 512(b)(13). If P leases the space to an unrelated third party ("U"), U can deduct the rent, and it will not be taxable to P. The after-tax return from the building is lower, so the argument goes, when P leases space to S than when it leases to U, causing exempt organizations to be driven away from contractual relationships with subsidiaries and toward relationships with third parties. In addition, the rental income has nothing to do with capital P invests in S. If P used its control to cause S to pay above-market rent, *that* would shift UBTI from S to P, but only to the extent of the excess. Taxing P on the fair market rent received from S is overkill and represents an inefficient and arbitrary tax penalty, given the overall policy to exclude rent from UBTI. One point the opponents fail to address is why P chose to hold back the building (or cash, or patent, and so on) and lease it to S rather than contribute it along with the other capital needed to launch and operate the business.

²⁷³For the most comprehensive critique, complete with algebraic equations, see Harry L. Gutman, *Taxing Transactions Between Exempt Parents and their Affiliates*, 84 TAX NOTES 1081 (Aug. 16, 1999). Proposals

Defenders of § 512(b)(13) argue that an arm's length standard is inadequate because even in the absence of abusive pricing, P is not making a passive investment when it leases the building to S (as it would be if it rented the building to an outsider).²⁷⁴ They contend that excluding arm's length payments from a controlled subsidiary would permit the exempt parent to get a tax-free return on capital used in an active business that it controls. Consider this comparison. Assume P owns a building and uses it in an unrelated trade or business conducted directly by P rather than through a subsidiary. P is taxed on the net profits from this business, including its "implicit return" on all its capital, including the building. If P opts to operate the business through S, and S could deduct the rent payable to P, less tax would be payable than if P ran the business directly or contributed the building to S. Allowing an "internal deduction" in these circumstances results in less overall tax liability to the P/S group than if P operated the business directly or S owned and used the building -- the very result § 512(b)(13) is supposed to prevent.

This is a difficult issue on which the author (and others) have wavered. At this writing, and reserving the right to be persuaded otherwise, the current approach to § 512(b)(13) seems appropriate to prevent a conversion of taxable trade or business income to excludable investment income in situations where the income-producing property is owned by the exempt organization and used in an unrelated trade or business. Moreover, importing § 482 transfer pricing principles, with all their attendant valuation disputes and opportunities for manipulation, seems unwise if only because it would be so

have been introduced to incorporate an arm's length standard into § 512(b)(13). Several were included in recent tax bills approved by Congress but vetoed (for other reasons) by President Clinton.

²⁷⁴See, e.g., Michael Schler, *Letter to the Editor: The Implicit Rationale for Section 512(b)(13)*, 84 TAX

difficult to administer. In this area, if in doubt, going with the bright line rule is the safer solution.

But a valid lingering question is -- how should control be defined? Even under current law, the look-through rule of § 512(b)(13) is avoidable if a group of exempt organizations form a subsidiary to operate a taxable business. Assume, for example, that four prestigious universities each own 25% of the stock of a C corporation that operates an online "e-learning" university, each licensing technology, alumni lists, and other tangible property as agreed.²⁷⁵ Since none of the universities are related to each other and none have 50% control, royalty payments should retain their exclusion from UBTI. If this is an abuse, § 512(b)(13) will not correct it.

3. Liquidation of a Taxable Subsidiary

A C corporation that completely liquidates generally recognizes gain or loss on sales or distributions of its property pursuant to the liquidation plan.²⁷⁶ On the liquidation of a controlled (i.e., 80% or more) C corporation subsidiary, however, neither the parent shareholder nor the liquidating subsidiary generally recognizes any gain or loss.²⁷⁷ The transaction is regarded as a mere change in form, and the subsidiary's tax attributes, including built-in gain or loss on its assets, are preserved in the hands of the distributee

NOTES 1329 (Aug. 30, 1999).

²⁷⁵See, e.g., Bill Workman, *Top Universities Join E-Learning Experiment*, S.F. CHRONICLE, Oct. 2, 2000, at B2, which describes such an alliance between Stanford, Oxford, Yale and Princeton.

²⁷⁶I.R.C. § 336(a).

²⁷⁷I.R.C. §§ 332, 337.

parent through attribute carryover rules.²⁷⁸ If the parent is a tax-exempt organization, the deferral provided by these general rules would be converted into a permanent exemption from corporate-level tax. Consider the following possibility. A and B, the sole shareholders of X corporation, which holds highly appreciated assets, wish to sell the company and avoid at least one level of tax. They sell their stock to tax-exempt Charity and recognize shareholder-level capital gain. Charity now owns 100% of the X stock and decides to liquidate X in a transaction that would be tax-free at both the corporate and shareholder levels under §§ 332 and 337. Although Charity takes a transferred basis in the appreciated assets distributed by X, no tax ever would be collected on Charity's subsequent sale of those assets (assuming they are not dealer property or used in an unrelated business) because Charity is exempt from tax. A similar avoidance opportunity would be presented if A and B *contributed* their X stock to Charity, which liquidated X. If Charity is not a private foundation, A and B properly could claim a charitable contributions deduction at fair market value without recognizing any gain on their X stock. But should X also be able to avoid corporate-level gain when it is liquidated and distributes its assets to Charity?

Congress properly concluded that the answer to the preceding question is "no." When it repealed the fabled *General Utilities* doctrine in 1986, a valid concern was that corporate-level gain recognition could be avoided if a taxable subsidiary were liquidated into a tax-exempt organization. Section 337(b)(2) thus provides that the normal

²⁷⁸See, e.g., I.R.C. § 334(b)(1).

nonrecognition rules do not apply where the parent is tax-exempt unless the distributed property is used by the tax-exempt parent in an unrelated trade or business immediately after the distribution. In that event, there is no abuse to be policed because the exempt organization will be subject to tax on its UBTI. Section 337(d) delegates authority to the Treasury to issue regulations to ensure that the policy of *General Utilities* repeal will not be subverted by various devices that are not specifically covered in the statute.

Final regulations issued in 1998 extend the anti-avoidance rule in § 337(b)(2) to asset transfers other than liquidations. For example, a for-profit corporation must recognize gain when it converts to nonprofit status.²⁷⁹ The scope of the regulations has been challenged by special pleaders, who question whether the Treasury had the authority to tax asset transfers to charity beyond the liquidation setting. They argue that the gain recognition bias of the regulations conflicts with the policy of § 170, which permits a fair market value charitable deduction for gifts of appreciated capital gain property and allows the donor to escape recognition of gain on the transfer. Assuming that policy is sound (and responsible commentators have questioned it), permitting nonrecognition of corporate-level gain on the transfer of an entire business to charity would be a double dip that undermines the integrity of the corporate income tax base, which is the very policy underlying *General Utilities* repeal.²⁸⁰

²⁷⁹Treas. Reg. § 1.337(d)-4(a)(2).

²⁸⁰There might be some cases where the corporation itself as distinguished from the shareholders intended to make a charitable gift of appreciated assets. The Preamble to the § 337(d) regulations observes that such a gift could occur with respect to a portion of a corporation's assets, but the regulations seem to assume no possible donative intent when substantially all of the corporation's assets are transferred in a liquidation or comparable change in status transaction. T.D. 8802, 63 Fed. Reg. 71591 (Dec. 29, 1998).

4. Impact of Integration Proposals

This meandering survey has revealed the intrusion of a fundamental principle of tax law that goes beyond the UBIT's preoccupation with unfair competition. The "all business income should be taxed at least once" principle is at the heart of the UBIT's treatment of S corporation income and, to a lesser extent, its approach to income from partnerships, LLCs, and certain types of foreign source income, as well as liquidations of taxable subsidiaries, and payments of otherwise passive investment income from controlled subsidiaries to their tax-exempt parents. The principle is sometimes breached, as in the case of a payment of tax-deductible interest by a U.S. corporate borrower to a tax-exempt or foreign lender. In that situation, income earned by the corporation is taxed at neither the corporate nor investor level, but these breaches are not grounded in UBIT policy but rather in the much criticized tax bias favoring debt over equity.

The proper tax treatment of earnings attributable to a corporation's charitable shareholders is a major pressure point in the on-and-off debate over whether to integrate the corporate and individual income taxes.²⁸¹ Discussion of the deficiencies of the double-tax Subchapter C regime have been ongoing for decades, and none are likely to be implemented in the author's remaining actuarial life expectancy. If integration ever were to be seriously considered, however, the impact on tax-exempt shareholders would be central to the policy debate. It is not inevitable that corporate-source income attributable

²⁸¹See generally Michael J. Graetz and Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767 (Sept. 27, 1999).

to tax-exempt investors would automatically be tax-free as a result of integration.²⁸²

Consider how tax-exempt investors would (or should) be treated under four leading integration options, simplified for purposes of this discussion: (1) repeal the corporate income tax and adopt a pass-through taxing regime akin to Subchapter K or S; (2) adopt a shareholder imputation credit model under which corporations would continue to pay tax at an agreed-upon rate, and shareholders would report dividends in income along with the tax already paid at the corporate level and then claim a tax credit for the taxes previously paid with respect to the dividend and "withheld" by the corporation; (3) allow a corporate-level deduction for dividends paid; or (4) allow a shareholder exclusion for dividends received.

Option 1 would be cumbersome if not impossible to administer. But assuming it were feasible for all public companies to provide annual K-1's to their shareholders, the choices for tax-exempt investors would be: (1) the current Subchapter S/UBIT model, which passes through to charitable shareholders their entire pro rata share of corporate income items, regardless of source; (2) the current partnership/UBIT model, which taxes income from an active entity-level business but not passive investment income flowing through to the tax-exempt partners; (3) a third model that would not tax *any* type of income realized by the entity to the extent it is attributable to an exempt owner. The charitable sector would be hard pressed to make a case for the "no tax" model.

²⁸²See generally U.S. Dept. of Treasury, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Jan. 1992) [hereinafter "1992 Treasury Integration Report"]; American Law Institute, FEDERAL INCOME TAX PROJECT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY (1993) (Alvin C. Warren, Jr., Rep.) [hereinafter "ALI INTEGRATION STUDY"].

When it proposed Option 2 (the shareholder imputation credit approach), the American Law Institute recommended that a single level of tax should be imposed on corporate income received by tax-exempt investors, and that tax should be designed to eliminate tax-induced distortions in investment decisions.²⁸³ Without getting into nuances and details, the ALI study would have imposed a new tax on corporate investment income (including capital gains of exempt organizations, which would be entitled to a credit for corporate taxes already paid on the same basis as other investors.²⁸⁴ The overall effect of this prototype is to tax corporate earnings at the shareholder's rate. If the § 512(b) exclusions were retained under an imputation system with a refundable credit, all levels of tax on corporate earnings distributed to exempt shareholders would be eliminated.

Under Option 3, the corporate-level deduction for dividends paid, the question would be whether dividends should be taxable when received by tax-exempt investors. It seems inconceivable that the § 512(b) exclusion for dividends could survive in the unlikely event that this approach were adopted because it would mean that a large share of corporate earnings distributed by U.S. public companies would not be taxed. Moreover, taxing neither dividends nor interest paid to tax-exempt investors would distort the choice between corporate and noncorporate investment if the UBIT continued to tax business income from partnerships, LLCs and S corporations. If neutrality between debt and equity were the goal, another approach would be to tax interest on corporate debt earned by tax-exempt investors or retain the current exclusion and eliminate the corporate-level

²⁸³ALI INTEGRATION STUDY, *supra* note 282, at 7-8.

²⁸⁴*Id.* The ALI did not take a position on the rate of tax to be imposed on exempt organizations other

interest deductions.²⁸⁵

Option 4, the dividend exclusion, was favored by the Treasury in its 1992 study because it provided significant integration benefits while avoiding major disruption to the Code. Corporations would pay the corporate income tax, much as they do now, on both distributed and retained income, but distributions from fully taxed corporate earnings would not be taxed again at the investor level. As under the current system, income from equity investments by exempt organizations would be subject to only one level of tax at corporate rates. To achieve neutrality between debt and equity investments, however, the tax burden on interest would need to be increased.

5. Summary and Conclusions

The preceding discussion bears only tangentially on UBIT line drawing issues, but it does serve to highlight a parallel policy that transcends the conventional UBIT unfair competition rationale or the doctrinal distinctions between business and investment activities. Business income, unless substantially related to an organization's exempt purposes, should be subject to at least one level of tax, irrespective of the form in which the business is conducted and whether or not the tax-exempt owner is a "player or an "investor." If that premise is accepted, the policy debate would shift to the appropriate rate of tax and whether it should vary depending on the various categories of exempt

than to suggest that it could be set to maintain the same level of revenue currently collected on corporate income distributed to exempt shareholders, or at a higher or lower rate, depending on tax policy objectives.

²⁸⁵The Treasury report suggested taxing interest and dividends at a single rate (not necessarily the § 11 corporate rate or the § 1 trust rates -- i.e., the rate could be lower) if Option 3 were adopted. *1992 Treasury Integration Study, supra* note 282, at 70.

shareholders.

D. Joint Ventures

1. Typical Settings

Joint ventures between charitable nonprofits and for-profit partners emigrated from the theater district to health care and low income housing, then to education, and now they are spreading like a virus throughout the sector. The term joint venture, by its very nature, suggests a sufficient level of activity to constitute a trade or business, but formats vary, as do the roles played by the nonprofit partner, which could be an active participant (i.e., general partner), a major investor (e.g., holding a 50% interest in an LLC), or a minority owner. Structures attracting the most attention are whole hospital and ancillary joint ventures. In a whole hospital joint venture, the venture is the sole or primary activity of the exempt organization. Typically, a nonprofit health care provider joins forces with a for-profit company to form an LLC to which the nonprofit contributes all its assets (e.g., an acute care hospital) and the for-profit contributes capital, including cash and possibly some operating assets.²⁸⁶ The nonprofit may or may not have any day-to-day management authority. In the usual case where it is not involved in management, the nonprofit survives as a grantmaking entity, but for tax purposes it is deemed under the aggregate theory to be engaged as well in the LLC's activities. The joint venture is said to

²⁸⁶Some joint ventures are solely between tax-exempt organizations -- e.g., two § 501(c)(3) health care providers that wish to operate their facilities as a combined entity without a merger. Assuming the joint venture does not stray from its charitable mission or engage in unrelated business activities, the Service has ruled that such an arrangement would neither jeopardize the exemption of the venturers or result in UBTI. *See, e.g.*, P.L.R. 97-220-42 (June 4, 1997).

be "whole" because it is the substantial or sole activity of the exempt organization, apart from grantmaking.

In an ancillary joint venture, the exempt organization does not contribute all of its operating assets nor is its participation in the venture its sole activity.²⁸⁷ In a hospital ancillary joint venture, for example, the activity conducted could be a core function (e.g., the anesthesiology department), or a relatively insubstantial activity (e.g., a dialysis unit), or a support function (e.g., a laundry). In a university setting, an ancillary joint venture might be a technology alliance, an on-campus Hilton Hotel, an agreement between the education department with a video conferencing facility to teach teachers how to use technology, or a link between the law or business school and a for-profit publisher or continuing education provider.²⁸⁸

Although some commentators have used the term "joint venture" to encompass participation by exempt organizations in investment pools or direct minority investments in start-up companies, those situations do not really fit the mold and are not within the scope of the discussion to follow.

2. Tax Issues

a. *Exempt Organization as General Partner.* Initially, the Service took the position that a § 501(c)(3) organization serving as a general partner in a joint venture with limited partner investors could not qualify for exemption because its core "charitable" mission

²⁸⁷See generally Mary Jo Salins, Judy Kindell & Marvin Friedlander, *Whole Hospital Joint Ventures*, FY 1999 IRS EXEMPT ORGANIZATIONS PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM 1 (1998).

necessarily would be secondary to its fiduciary duty to maximize profit for the for-profit investors. In the *Plumstead Theatre* case, the Tax Court disagreed, holding without much discussion that a charity's participation as a general partner in a limited partnership did not jeopardize its exempt status where, on the facts, the purpose of the venture was to advance its charitable purposes, the exempt organization retained control, and the arrangement did not result in any private benefit to the for-profit investors.²⁸⁹ The Service now concedes that a § 501(c)(3) organization may form and participate in a partnership or LLC and meet the operational test if its participation furthers a charitable purpose (e.g., education or the promotion of health), the partnership agreement permits the exempt organization to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of the for-profit partners, and as a legal and practical matter the exempt organization has sufficient control (the magic word) to ensure that these requirements are met.²⁹⁰ Numerous letter rulings, mostly in the area of health care and low income housing, outline the positive and negative fact pressures.

b. *Whole Hospital Joint Ventures*. In a typical whole hospital joint venture, the exempt organization and a for-profit company each hold ownership interests in an entity (usually an LLC) that operates the venture. To determine whether the exempt organization qualifies for exempt status, the Service scrutinizes the ownership and governance structure of the LLC and attributes its operations back to the owners -- an aggregate approach that ordinarily would not be used if the exempt organization held

²⁸⁸Some of these examples have been cribbed from discussions at ABA Tax Section meetings.

²⁸⁹*Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

stock of a C corporation that engaged in the activity. If the organization's participation in the venture furthers a charitable purpose, and the governance structure permits the organization to act in furtherance of that purpose and only incidentally to benefit the for-profit partners, the organization's exemption remains secure -- unless the for-profit partner has effective voting control.

In *Redlands Surgical Services v. Commissioner*,²⁹¹ the Tax Court agreed that control was a significant factor but did not hold that an exempt organization's lack of voting control was fatal to § 501(c)(3) exemption. Also relevant was the organization's power to compel the venture to operate in manner consistent with its exempt purposes; governance (who is on the board and what impact does this have on control?); valuation (were the contributions of the venturers fairly valued relative to the economic interests they took back?); management (are the day-to-day managers affiliated with the for-profit partner?); and other private agendas (does the arrangement provide inappropriate benefits to private physicians?; are percentage of net profits compensation arrangements utilized?) In the real world, it is doubtful that a for-profit co-venturer will cede control. Whether or not the Service's "control per se" test -- a hard line opening bid -- will survive judicial scrutiny is one of the issues on appeal in *Redlands Surgical Services*.

Larger issues are at stake here than the line between business and investment. The dispute over whole hospital joint ventures raises the recurring question of whether modern health care providers still fit within the concept of charitable, or whether, like Blue Cross

²⁹⁰Rev. Rul. 98-15, 1998-1 C.B. 718.

²⁹¹113 T.C. 47 (1999), *appeal pending* (9th Cir.).

and TIAA/CREF, they should be evicted from § 501(c)(3) and shuttled to a different tax regime. Until that happens, the area remains a swamp. From a planning standpoint, the safe course is to isolate any substantial nonexempt activities in a taxable subsidiary, which can act like any other normal for-profit taxpayer and engage in legal maneuvers to minimize the bottom line without fear that its activities will be attributed back to its exempt parent.²⁹²

c. *Ancillary Joint Ventures.* Guidance is sparse on the more prevalent ancillary joint venture, which also raises qualification and UBIT issues. A few general observations are provided here to sort out the possibilities. If the activity conducted by an ancillary joint venture is both substantial²⁹³ and unrelated to the organization's exempt purposes, the organization's exemption will be threatened unless it insulates itself by using a taxable subsidiary. If the venture is a substantial but "related" activity, qualification would not be jeopardized unless the arrangement results in inurement or private benefit. It is not clear whether the exempt organization's lack of voting control automatically results in forbidden private benefit even where the for-profit partner's economic deal is commensurate with its capital commitment, but it should not be fatal if the activity is

²⁹²A digression begins to examine this aspect. Assume (Situation 1) that an exempt organization's only asset is 100% of the stock of a C corporation that holds a 50% (or lower) interest in a joint venture (an LLC) with a for-profit company to operate an acute care hospital. Assume, alternatively (Situation 2) that an exempt organization's only asset is a direct 50% (or lower) interest in the LLC. In both situations, the exempt organization makes grants for community health care. If, as seems to be the case, the organization in Situation 1 qualifies for exemption but the organization in Situation 2 does not, does the result make sense? And while we're at it, assume (Situation 3) that a grantmaking public charity's only asset is 100% (or less) of the stock of an S corporation engaged in an unrelated business. Will the charity qualify for § 501(c)(3) status even though all of its income is UBTI? If so, to what extent can the UBTI bottom line be minimized or eliminated through charitable deductions for grants or other expenses related to the organization's exempt mission, and does it matter whether the charity is a nonprofit corporation or a trust (it does)? See I.R.C. §§ 512(b)(10), (11).

operated in a charitable manner and sufficient safeguards exist to protect against more than incidental private benefit in the future. If exemption is not threatened because the ancillary activity is insubstantial but the venture regularly engages in a trade or business, the inquiry shifts to the UBIT.

In the last analysis, assuming no inurement, the joint venture cases are not all that different from the many exemption qualification controversies implicating the murky commerciality doctrine, and the UBIT cases turning on relatedness. As such, they are vintage wine decanting in a new bottle. The news is not good for those seeking bright line tests and tidy results. With apologies to Judge Posner,²⁹⁴ until the Service or the courts provide better guidance on real world cases rather than polar extremes, all the facts and circumstances will control, no single factor should be determinative, and it all comes down to the not-yet-clearly-articulated rationale for charitable tax exemption and the UBIT.

V. LOOSE ENDS

This Part addresses a few loose ends of general interest or of particular interest to the author. Although somewhat tangential to the general topic of this paper, they merit brief attention in any comprehensive survey of the tax consequences of nonprofit investments.

A. Charitable Split-Interest Trusts

²⁹³An unresolved question is when holding an interest in a joint venture is substantial.

²⁹⁴*See* United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173 (7th Cir. 1999) (observing that a "facts and circumstances" test for private benefit "is no standard at all, and makes the tax status of charitable

Split-interest trusts are hybrid charities that can be profoundly or only marginally affected by the UBIT. The dimensions of the problem are relatively unknown because no reliable data is available on the dollar value or investment characteristics of split-interest trusts, which are not subject to the public disclosure requirements generally applicable to private foundations and public charities. Although some abusive uses of charitable remainder and lead trusts have been publicized and largely corrected,²⁹⁵ information on the investment behavior of split-interest trusts remains mostly in the shadows.

1. Charitable Remainder Trusts

The major allure of a charitable remainder trust ("CRT") is its exemption from income tax. A lifetime grantor can fund the trust with a low basis asset, which the trustee then sells free of tax, reinvesting the proceeds in a diversified portfolio. Going forward, any growth in the CRT in excess of the required payout to the income beneficiary is also tax-free, much like a qualified pension fund. In the case of an annuity trust, the growth inures solely to the benefit of the charitable remainder beneficiary, while in the more popular unitrust format the income and remainder beneficiaries share the advantages provided by tax-free compounding. In either format, a responsible CRT fiduciary should invest for total return, employing the same approach to asset allocation and risk as do managers of pure charitable endowments.

organizations and their donors a matter of whim of the IRS").

²⁹⁵See, e.g., Janet Novack, *The New Giving Game*, FORBES, Sept. 20, 1999, at 180. Prop. Treas. Reg. § 1.643(a)-8 (1999).

A CRT loses its tax-exempt status in any taxable year in which it has UBTI within the meaning of § 512.²⁹⁶ In that event, the CRT's entire net income, not merely the UBTI, is taxable under the trust rates in § 1(e),²⁹⁷ which reach the 39.6% bracket at \$8,650 of taxable income in 2000. A CRT with a traditional investment portfolio of domestic securities rarely will be trapped by this draconian rule. But once a CRT starts to behave like a sophisticated institutional investor -- or perhaps as the result of an unwitting foot fault by a money manager or custodian -- a CRT can jeopardize its exemption. The typical spoilers are income from debt-financed property or an interest in a partnership or LLC that conducts an active business or otherwise passes through some UBTI. Our earlier discussion illustrates a wide range of other possible UBIT-generating investments, such as: REMIC residual interests; REITs holding REMIC residual interests; derivatives and other financial instruments whose status is unclear; direct investments in certain contingent debt instruments; stocks in foreign corporations that may directly or indirectly (e.g., through a subsidiary) have Subpart F insurance income; hedge funds utilizing the type of leverage that rises to the level of acquisition indebtedness; and private equity investment partnerships that may realize debt-financed income because of a bridge loan or an investment in a start-up company formed as an LLC.

²⁹⁶I.R.C. § 664(c); Treas. Reg. § 1.664-1(c). In view of the \$1,000 "standard deduction" in § 512(b)(12), a CRT with \$1,000 or less of pre-deduction UBTI winds up with a zero bottom line and does not have any UBTI, as defined. Thus, a CRT's tax exemption for the year should not be threatened if it inadvertently generates an amount of UBTI falling below the \$1,000 deduction. The conventional warning nonetheless seems to be that even \$1 of UBTI (without regard to the § 512(b)(12) deduction) will cause a CRT to be taxed on all of its income.

²⁹⁷For the resulting fallout and the strange interaction of the charitable remainder trust rules and Subchapter J in this unpleasant scenario, see Leo L. Schmolka, *Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism*, 40 TAX L. REV. 1, 63-65 (1984).

The no-UBIT rule quietly entered the Code as part of Congress's orgy of recrimination against private foundations and split-interest trusts in the Tax Reform Act of 1969. It was explained by a single sentence in the Senate Finance Committee report:²⁹⁸

The Committee does not believe that it is appropriate to allow the unrelated business income tax to be avoided by the use of a charitable remainder trust rather than a tax-exempt organization.

A reasonable interpretation of the rationale is that Congress intended to tax only the UBTI of a CRT, not to cause the CRT to lose its entire exemption because of any UBTI. But the plain language of the statute (a CRT will be exempt from tax "unless such trust, for such year, has unrelated business taxable income") supports the broader cliff effect rule adopted by the regulations,²⁹⁹ and the only courts to consider the issue, finding no ambiguity in the statute, support the regulations.³⁰⁰

The no-UBIT rule has a chilling effect that severely limits the investment options of a CRT. Without heroic measures³⁰¹ and day-to-day monitoring of the portfolio by the most knowledgeable of tax advisors, the tools and techniques of the modern institutional investor are simply unavailable to the large pool of charitable capital currently residing in CRTs. The solution, which must come through legislation, is not necessarily to allow a CRT to have unlimited UBTI but rather to tolerate a certain permissible level that would

²⁹⁸S. Rep. No. 552, 91st Cong., 1st Sess. 90 (1969).

²⁹⁹Treas. Reg. § 1.664-1(c).

³⁰⁰*See* Leila G. Newhall Unitrust v. Commissioner, 104 T.C. 236 (1995), *aff'd*, 105 F.3d 482 (9th Cir. 1997).

³⁰¹The use of a wholly owned foreign "blocker" subsidiary, as already discussed, is an option, but the expense of establishing a foreign corporation in a U.S. tax haven is rarely justified. It is simpler to confine investments to domestic stocks and bonds and mutual funds. The author has anecdotal knowledge of investment products being marketed privately to large CRTs but promoters seem unwilling to give an absolute guarantee that UBTI will be avoided. A cautious CRT trustee is unlikely to tolerate any such tax

be subject to tax without causing the CRT to lose its tax-exempt status.

2. Charitable Lead Trusts

In a charitable lead trust ("CLT"), a specified annuity or unitrust amount is paid to charity, usually for a term of years, and the remainder passes to private individuals, such as the grantor's children or grandchildren. The nongrantor CLT, which is by far the most prevalent format, is a device to shift wealth to younger generations while minimizing wealth transfer tax. The strategy is most effective when the grantor is otherwise philanthropic and can fund the CLT with an asset that will grow beyond the rate of return assumed by the actuarial tables used to value the "family remainder" interest at the time the trust is created. Investments in CLTs are not always diversified, especially when the trust is funded with assets such as closely-held pre-IPO stock with high growth potential but no current liquidity.

Unlike CRTs, nongrantor CLTs are fully taxable complex trusts under Subchapter J of the Code, but CLTs are entitled to an unlimited (i.e., no percentage limits) charitable deduction under § 642(c) for payments of gross income that, pursuant to the governing instrument, are paid to qualifying charitable organizations. To maximize the charitable deduction, most well drafted CLTs provide that contributions should be made first from ordinary income, then from capital gain, and then from UBTI, tax-exempt income, and corpus in that order. Absent this dictate, amounts are deemed to come pro rata from all

risk.

the categories of income in the trust.³⁰²

Because CLTs are fully taxable, the UBIT at first glance seems irrelevant in this context. But in fact, it does have marginal significance in that UBTI in a CLT can reduce an otherwise allowable charitable deduction.³⁰³ Assume, for example, that a CLT with a charitable payout obligation of \$100,000 per year has \$200,000 of gross income of which \$60,000 (30%) would have been UBTI if the CLT were a tax-exempt organization.³⁰⁴ In this situation, the Service's position is that the \$100,000 paid to charity is treated as coming 30% from UBTI, initially limiting the CLT's charitable deduction under § 642(c) to \$70,000, notwithstanding ordering provisions in the trust instrument requiring charitable contributions to be made first from sources other than UBTI or tax-exempt income.³⁰⁵ A portion of the \$30,000 treated as payable from UBTI then may also be deductible as a charitable contribution under § 512(b)(11), subject to the appropriate percentage limitations in §§ 170(b)(1)(A) and (B), substituting UBTI (before any charitable deduction) as adjusted gross income for this purpose.

As a policy matter, these rules make sense if one accepts the underlying premise of the UBIT because they prevent sheltering what would be taxable UBTI through the unlimited charitable deduction available to a CLT. This interaction of the UBIT with

³⁰²Treas. Reg. §§ 1.643(a)-5(b); 1.662(b)-2.

³⁰³I.R.C. § 681(a). For this purpose, unrelated business income means an amount equal to the amount that would be UBTI if the trust were an exempt organization. Part of a charitable deduction disallowed under this rule then may be restored by § 512(b)(11), which allows a trust a charitable deduction for payments to qualified charities made from UBTI subject to the percentage limitations in § 170 (i.e., 30% or 50%, depending on the status of the charity.)

³⁰⁴The UBTI could result from: an interest in a partnership or LLC operating an active business, debt-financed income from real estate investments, a margin account, or a hedge fund investment.

³⁰⁵See Treas. Reg. § 1.681(a)-2.

§ 642(c) as applied to CLTs is not well understood by estate planners, CLT tax preparers or the Service.

B. Private Foundations

1. § 4940 Tax on Net Investment Income

Private foundations are subject to a 2% excise tax on their net investment income under § 4940. Net investment income generally consists of interest, dividends, rents, royalties, and capital gain net income, and is reduced by expenses incurred to earn the income. The tax rate, originally set at 4%, was justified as a special fee to finance the costs of auditing private foundations and enforcing the regulatory scheme adopted in 1969.³⁰⁶ The 2% rate is reduced to 1% in any year in which a foundation's charitable distributions exceed its historical distribution level for the preceding five years.³⁰⁷ Periodic studies have revealed that receipts from this "audit tax" have far exceeded the costs of administration, and the tax has been a persistent source of controversy.³⁰⁸ The foundation community sees it as a punitive measure that reduces funds available for charitable purposes and unfairly singles out foundations. Supporters of the tax, deflecting its initial rationale, argue that foundations, especially those with large endowments, should help pay for some of the costs of government.

The § 4940 tax rests on the shakiest of rationales. If the policy is that wealthy

³⁰⁶STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX REFORM ACT OF 1969, 91ST CONG., 2D SESS. 29 (1970).

³⁰⁷I.R.C. § 4940(e).

³⁰⁸For example, for its fiscal year ending September 30, 1998, the Ford Foundation, which qualified for the 1% rate, was liable for \$10.1 million in § 4940 tax on net investment income for the year of \$1.007

charities should share in the general costs of government, the tax should be extended to all § 501(c)(3) organizations and a generous standard deduction should be provided to exclude small and mid-sized charities from the tax base.³⁰⁹ Another salutary reform, proposed in the Clinton Administration's 2001 budget submission, would be to replace the present two-tier excise tax with a single flat rate (e.g., 1.25% or lower) regime.³¹⁰

2. Unrelated Business Income Tax

Private foundations also are subject to the UBIT³¹¹, but as a practical matter relatively few foundations realize the most prevalent forms of "trade or business" UBTI because of the prohibition on excess business holdings. Foundations making nontraditional investments face the same UBIT problems as a university endowment or other wealthy charity. The usual sources of UBTI are partnership investments, such as hedge funds, and debt-financed real estate investments. Based on the author's unscientific and incomplete review of the most recently available Form 990-PFs filed by nine of the largest private foundations in the United States, very little UBIT is paid and, indeed, many

billion. Ford Foundation, Form 990-PF.

³⁰⁹See George Break & Joseph A. Pechman, *Relationship Between the Corporation and Individual Income Taxes*, *National Tax J.* 341, 344 (1975), where the authors suggest the possibility of extending the UBIT to investment income of all exempt organizations, even in the absence of corporate integration, on the theory that investment income in large amounts may serve mainly to protect the recipient institution from any market test of the value of its activities.

³¹⁰See STAFF OF JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL [hereinafter "PRESIDENT'S 2001 BUDGET PROPOSAL"] 231-234 (JCS-2-00) (2000).

³¹¹To avoid double taxation, any UBTI realized by a private foundation is not included in "gross investment income" for purposes of the § 4940 tax. I.R.C. § 4940(c)(2). UBTI also may have an impact on whether or not organization can avoid private foundation status under the public support tests in §§ 170(b)(1)(A)(vi) and 509(a)(2).

foundations with assets in the billions do not even file a Form 990-T.³¹² Those foundations incurring UBIT presumably treat it as a tolerable cost of making certain investments that promise to earn a sufficiently high return.

3. Jeopardy Investments

In theory, the § 4942 income distribution requirements and the sanctions against excess business holdings should encourage foundations to maintain a diversified and reasonably productive investment portfolio. Congress also was concerned about investments that would jeopardize a foundation's charitable purposes. To ensure that a foundation's portfolio strategy creates no more than a tolerable level of risk, § 4944 imposes an excise tax of 5% on any amount invested by a private foundation "in such a manner as to jeopardize the carrying out of any of its exempt purposes."³¹³ Although § 4944 sounds like a federal version of the old Prudent Man Rule, it really is a more progressive quasi-corporate standard of care along the lines of the business judgment rule.

According to the regulations, a jeopardy investment occurs:³¹⁴

if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

Jeopardy is relative. Thus, a foundation with \$10 million portfolio including \$1 million in speculative growth stocks in various industries will not likely be subject to any

³¹²See Appendix A, to be distributed at the conference, for selected data on the UBIT liability of large private foundations.

sanctions. On the other hand, a foundation that risks nearly all of its endowment in speculative ventures should not survive audit scrutiny. The determination of jeopardy turns on all the facts and circumstances, including "the need for diversification."³¹⁵ The following investments are considered worthy of "close scrutiny:" margin trading; commodity futures; working interests in oil and gas wells; options and straddles; warrants; and short sales.³¹⁶ Many of today's nontraditional investments might have been added to this list if the Treasury had known about them when the regulations were promulgated.³¹⁷

Although some aspects of the jeopardy investment standard are dated (e.g., singling out certain risk management strategies for "special scrutiny"), their overall tenor is quite liberal, as is the Service's ruling policy. For example, the regulations do not automatically condemn investments in raw land, a promising new business venture, or stock with an uneven earnings record.³¹⁸ The Service also has ruled that junk bonds, a high-risk investment in a gold mine, commodity futures, covered options and various types of market-neutral and other nontraditional investment strategies typically employed by hedge funds are not jeopardy investments when viewed as part of an overall diversified portfolio.³¹⁹

³¹³I.R.C. § 4944(a).

³¹⁴Treas. Reg. § 53.4944-1(a)(2)(i).

³¹⁵Treas. Reg. § 53.4944-1(a)(2)(i).

³¹⁶Treas. Reg. § 53.4944-1(a)(2).

³¹⁷Notably excepted from the § 4944 penalties are program-related investments, which are defined as investments "the primary purpose of which is to accomplish one or more of the [charitable, religious, etc.] purposes described in section 170(c)(2)(B) and no significant purpose of which is the production of income or the appreciation of property." I.R.C. § 4944(c). See Treas. Reg. § 53.4944-3(a), (b).

³¹⁸Treas. Reg. § 53.4944-1(c).

³¹⁹See, e.g., Tech. Adv. Memo 87-180-06 (Feb. 2, 1987) (gold mine); P.L.R. 92-37-035 (June 16, 1992)(commodity futures); P.L.R. 94-51-067 (Sept. 28, 1994) (distressed real estate; stock futures and forward contracts; commodities and currencies; small energy companies); P.L.R. 97-23-045 (March 12,

C. Mutual Benefit Organizations

Except for social clubs, voluntary employees' beneficiary associations, and a few other specialized entities,³²⁰ the UBIT applies to mutual benefit organizations much like it does to charities. Social clubs are granted exemption to enable their members to commingle together and provide personal benefits without adverse tax consequences. The theory for taxing investment and nonexempt function income of social clubs is that failure to do so would permit the members to finance their personal activities from tax-free endowments. The same could be said of fraternal societies. Their exemption from tax on investment income remains a historical curiosity best explained by their influence in Congress and, possibly, their historical commitment to charitable and educational (as well as fraternal) activities. Efforts by college fraternities to avoid tax on investment income by styling themselves as fraternal societies rather than social clubs have been unsuccessful.³²¹

Business leagues, trade associations, labor unions, and fraternal lodges are generally not taxable on their passive investment income unless it is debt-financed or received from a controlled entity. This exemption is more the product of inattention than of any thoughtful reflection. The shaky rationale was first exposed by Boris Bittker and George Rahdert in their classic Yale Law Journal article.³²² They concluded:

The activities of mutual benefit organizations that consist simply in

1997) (various alternative investments, none of which would represent more than 2% of the foundation's total portfolio).

³²⁰I.R.C. § 512(a)(3).

³²¹See *Zeta Beta Tau Fraternity, Inc. v. Commissioner*, 87 T.C. 421 (1986).

³²²Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L. J. 299 (1976).

the members' doing together what they could do separately without income tax consequences (such as buying food or operating social facilities) are not fit objects of taxation. But such organizations may also do business with nonmembers or invest in assets which produce income inuring to the benefit of their members. There is no reason to permit income of these types, which would be neither excludable nor deductible from taxable income in the hands of an individual, to escape taxation when acquired under the umbrella of an organization.³²³

Bittker and Rahdert also observed, however, that investment income of some business-oriented mutual benefit organizations, such as labor unions or trade associations, would not be taxed if it were imputed to the group's members and the income was used in the same year to defray expenses that the members could deduct (e.g., dues under § 162).³²⁴ The same "constructive wash" theory would justify the exemption for investment income accumulated for later use except for the time value of money advantage of imputing a deduction before the expenditure is actually incurred.

During the 1987 House Oversight Subcommittee hearings, the Treasury argued that the rationale for excluding the investment income from UBTI did not extend to mutual benefit organizations.³²⁵ The proposal did not attract much support, however, and withered on the legislative shelf until the Clinton Administration dusted it off in modified form in its fiscal year 2000 budget submission.³²⁶ The proposal tax trade associations at corporate rates on their net investment income over \$10,000 was seriously undermined by

³²³*Id.* at 358.

³²⁴*Id.* Under current law, dues paid by individual employee members of unions or trade associations (if not reimbursed by their employers) are miscellaneous itemized deductions -- deductible only by those who itemize deductions and then only to the extent that the taxpayer's total miscellaneous itemized deductions exceed 2% of adjusted gross income.

³²⁵1987 UBIT Hearings, *supra* note 127, at 47.

³²⁶*See* JOINT COMMITTEE ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL, 106TH CONG., 1ST SESS. 279-281 (JCS 1-99, Feb. 22,

its failure to apply to § 501(c)(5) labor, agricultural and horticultural organizations, among others. After the predictable outcry, it was declared dead on arrival, but an undaunted Clinton Administration included an identical "revenue raiser" as part of its FY 2001 budget submission.³²⁷

Although a solid theoretical case can be made for taxing the investment income of nonsocial mutual benefit organizations, a proposal targeting trade associations but not labor unions is difficult to take seriously, and the modest time value tax benefits of the current system may not justify the effort in any event. The point of this discussion is that the rationale for exempting investment income of charities is markedly different from the more tenuous policy decision to exempt investment income of mutual benefit organizations.

D. FOREIGN CHARITIES

Foreign charities can qualify for U.S. charitable tax exemption if they meet the tests for exemption in § 501(c)(3). Unlike § 170, which governs the charitable contributions deduction, the exemption standards do not include any "domestic" requirement.³²⁸ A foreign-supported foreign charity is treated as "described" in § 501(c)(3) and thus exempt from U.S. tax even if it does not request a formal determination of its status from the

1999).

³²⁷PRESIDENT'S FISCAL 2001 BUDGET PROPOSAL, *supra* note 309, at 435.

³²⁸*See generally*, Hill & Kirschten, *supra* note 258, ch. 13; Kimberly Blanchard, *U.S. Taxation of Foreign Charities*, 8 EXEMPT ORG. TAX REV. 719 (1993).

IRS.³²⁹ Some foreign charities nonetheless request a formal determination of their U.S. tax-exempt and public charity status and foreign charities deriving more than 15% of their support from U.S. contributors are well advised to do so.

Two quite different provisions of the Code may cause some investment income of foreign charities to be subject to U.S. tax. First, in lieu of the generally applicable § 4940 audit tax, foreign organizations that are private foundations (or would be under U.S. tax standards if anyone bothered to inquire) are subject to a 4% tax on their gross investment income derived from "sources within the United States" (within the meaning of § 861).³³⁰

Second, foreign charities are taxable on UBTI derived from sources within the United States and not effectively connected with the conduct of a U.S. trade or business, and UBTI which is effectively connected with the conduct of a trade or business within the United States, whether or not that income is derived from U.S. sources.³³¹ Because they are not included in UBTI, the usual forms of passive investment income should not be taxable to "(c)(3)-equivalent" foreign charities whether or not the income is derived from U.S. sources and, in the case of rents, even if the income would be treated as effectively connected to a U.S. trade or business for taxable foreign persons. On the other hand, debt-financed income from U.S. real property should be taxable to a foreign charity under the rules generally applicable to domestic exempt organizations. Assuming no debt-financing, gain on the sale of U.S. real property, which ordinarily is taxable to foreign

³²⁹I.R.C. § 4948(b).

³³⁰I.R.C. § 4948(a). For a discussion of whether § 4948 only applies to foreign organizations that have received an IRS determination letter or all foreign charities that would be classified as private foundations if they did apply, see HILL & KIRSCHTEN, *supra* note 258, at ¶ 13.04[2].

³³¹I.R.C. § 512(a)(2).

persons as "effectively connected" U.S. trade or business income, should qualify for the § 512(b)(5) exclusion if the investor is a foreign charity.³³²

VI. CONCLUDING OBSERVATIONS

1. Despite its shortcomings, the UBIT has withstood the test of time. It lurks as an "intermediate sanction" for organizations that stray too far afield from their exempt mission and plays a symbolic role that should not be underestimated. If the UBIT were completely repealed and the destination of income test fully restored, the revenue loss would be minimal but the potential economic distortions and perceptions of unfairness would outweigh the benefits. In any event, the realistic view is that repeal is not feasible, and constructive observers should focus on improvement of the current system.

2. The UBIT's principal trouble spots largely involve areas not related to the narrower focus of this conference. They include the need for a clearer and more rigorous test of relatedness, focusing on areas where it matters such as sales of merchandise, use of facilities, and other activities that are indistinguishable from those conducted by for-profit taxpayers. Other areas worthy of attention are familiar to UBIT historians and avoiders. They include allocation of expenses; statutory redundancy (the "convenience" exception); and disclosure (e.g., of activities of taxable subsidiaries).

3. Congress's decision to provide specific exclusions for passive investment income rather than to rely on general tax principles distinguishing business and investment has

³³²These are the author's tentative conclusions as this paper is being rushed to the copy machine, and as the author rushes to the major league baseball playoffs. The conclusions are based on intuition and common

eliminated many potential line drawing controversies. In any event, the distinctions drawn under general tax principles offer only minimal guidance because they arise in too many different contexts.

4. The UBIT was designed for an earlier era, long before the emergence of Modern Portfolio Theory and its emphasis on diversification and risk management. The Service's current approach to nontraditional sources of investment income, while long in coming, has been tolerant and constructive. Leaving aside problems of debt-financed income, a handful of statutory amendments along with a "similar forms of investment income" penumbra have combined to exclude most forms of income from now well-accepted risk management and absolute return strategies employed by institutional investors. If a problem exists, it is the Service's understandable inability to keep up with the flood of exotic new financial products, and the resulting lack of guidance to large charitable investors and their tax advisers. At worst, this appears to be a marginal problem, except (as noted below) for charitable remainder trusts.

5. The royalty exclusion has been exploited and, as generously interpreted by the courts, it goes well beyond its original purpose. If the § 512(b) exclusions are intended to exempt passive investment income from tax, it is a departure to extend the royalty exclusion to activities that, when viewed in isolation, are tantamount to joint ventures having no demonstrable relationship to the properly defined exempt functions of a § 501(c)(3) charity. The ability of well-advised nonprofits to segregate "royalty" income

sense rather than any controlling legal authority. As needed, corrections and refinements will be revealed at the conference.

from "services" income and minimize the taxable bottom line through creative allocation of expenses suggests that abuses in this area only can be curbed through legislation along the lines suggested in 1988 by the House Oversight Subcommittee.

6. As has been well chronicled for years, the debt-financed property rules go far beyond their stated purpose and stand as an irritant (though not a major impediment) to charitable investors in securities and real estate. The use of a reasonable amount of leverage is now accepted for investors in securities and related products, and leverage is the norm for legitimate real estate investments. At its core, § 514 is simply overbroad, but even if one accepts its current scope, it is poorly designed. No sound policy has been demonstrated for limiting the § 514(c)(9) exception to pension trusts and schools, and the rules to patrol abusive income-shifting between charitable investors and for-profit partners in real estate partnerships are unnecessarily complex and onerous when applied to real world transactions. The convoluted but creative offshore "blocker" structures marketed by hedge fund managers for their major tax-exempt investors are effective in mitigating problems of debt-financed income, even apparently for charitable remainder trusts, but at an efficiency cost. The appropriate cure is not a complex set of anti-abuse rules to curb offshore structures but a reexamination of the rationale and reach of § 514.

7. If the UBIT is to be taken seriously, at least one level of income tax should be imposed on the net profits from an unrelated business, irrespective of the form in which the business is conducted. The current rules for pass-through entities ensure this result, with some marginal overkill in the case of S corporation income, and the pressure to employ taxable C corporation subsidiaries for unrelated business activities also serves to

protect the integrity of the business enterprise tax base. Any distortions are the result of flaws in business enterprise tax policy (e.g., the tax bias for debt over equity) rather than UBIT policy, or more subtle issues relating to allocation of expenses or consolidation of related and unrelated businesses.

8. As for issues of qualification for exemption, form is too often elevated over substance -- so that the business activities of a pass-through entity are attributed back to their tax-exempt owner (regardless of business or investor status), while use of a wholly owned subsidiary, if properly structured, will not be considered in determining if the parent's activities are primarily charitable.

9. Most joint ventures raise familiar tax issues albeit in a different context. The Service's "per se" control rule for whole hospital joint ventures merely opens the bidding. A safe harbor approach, along with clearer guidelines for the more prevalent ancillary joint ventures, would have been more constructive. Reliance on the courts, particularly the Ninth Circuit in *Redlands Surgical Services*, is precarious. The familiar issues are: the scope of charitable (or educational), and the scope of relatedness -- the same question, really. The Service's hard line has not chilled the nonprofit sector's enthusiasm for joint ventures, and without more coherent guidance that solves real-world problems instead of addressing polar extreme fact patterns, the only recourse is to the dreary swamp of "all the facts and circumstances."

10. The bizarre and outmoded rule stripping a charitable remainder trust of its exempt status whenever it has even minimal UBTI unfairly restricts the investment options for a large and growing pool of charitable wealth. This "cliff effect" problem could be

corrected by fairly simple legislation that revokes a CRT's exempt status only if UBTI exceeds a certain level relative to its total income and otherwise limits any entity-level tax to the UBTI rather than the CRT's entire income.

11. The tenuous rationale for the § 4940 "audit tax" on investment income of private foundations was long ago exposed. The tax should be repealed or at least simplified along the lines of the Clinton Administration's FY 2001 budget submission. If the policy is that large charitable endowments should support some of the costs of government, it should be clearly articulated as such and the tax should be extended to all wealthy charities, not just foundations, with the policy debate turning to the proper tax base, the appropriate rate.

12. Although taxing investment income of mutual benefit organizations has some theoretical appeal, proposals to limit the tax to trade associations but not labor unions and fraternal societies cannot be taken seriously, and the whole effort may not be worth the trouble.