

Taxation of Unrelated Debt-Financed Income

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Tax-exempt organizations and qualified pension and profit-sharing plans generally are exempt from tax on passive investment income.¹ If the property producing such income is acquired with borrowed funds, however, the debt-financed property rules of section 514 treat all or part of the income as unrelated business taxable income with the result that it is subject to tax.

The debt-financed property rules were enacted in response to a specific problem – sale leaseback transactions that were viewed as abusive. Subsequent legislation focused on exceptions to the rules and the conditions to qualifying for such exceptions. But, while there has been frequent legislation regarding the taxation of debt-financed property, there has not been an overall review of the policy justification for taxing leveraged investments. After examining current law, the legislative history of the debt-financed property rules, and some of the problems with the rules, this paper will consider policy rationales for taxing leveraged investments of exempt organizations and qualified pension trusts in the context of the current UBIT regime. This paper will not question whether the unfair competition theory that underlies the UBIT is sound or whether a distinction between passive investment and active business income is sound. Rather, accepting the taxation of UBIT and the exclusions for passive investment income as a given, this paper will ask whether there is any policy justification for taxing otherwise exempt passive investment income when it is derived from property acquired with debt.

The question is important. Exempt organizations and pensions are a substantial source of capital for the economy. Yet, because the taxation of income significantly reduces the return on an investment, exempt organizations avoid any investment that carries a risk of being classified as debt-financed. Many investments do carry this risk. As one commentator has stated, the debt-financed property rules "complicate almost every substantial transaction . . . and serve as material constraints upon transactions that – outside the sphere of [exempt organizations] – would be characterized as routine investment activities."² The result is that exempt organizations are excluded altogether from many prudent and relatively routine investments³ or make these investments only after complying with complex and burdensome rules.

I. Overview of Current Law

¹ Sections 512(b)(1), (2), (3), (5). All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

² Weigel, *Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)*, 50 TAX LAW 625 (1997).

³ Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585-629 (1998).

A. Unrelated Business Income Tax

1. General Rule

Since 1950, exempt organizations have been taxed on unrelated business taxable income⁴, which is defined as gross income (less directly connected expenses) derived from an unrelated trade or business.⁵ An unrelated trade or business is defined as: (a) any trade or business; (b) that is regularly carried on; and (c) is not substantially related, aside from the need of the organization for funds, to the organization's exempt purpose.⁶

In most instances, investment activities of exempt organizations would be regularly carried on and not substantially related to the organization's exempt purpose, thus meeting the second and third prongs of the definition of an unrelated trade or business. It is less clear whether the conduct of investment activities constitutes a trade or business. The regulations provide that, in general, the term "trade or business" has the same meaning it has in section 162 and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.⁷ In 1941, the Supreme Court held in *Higgins v. Commissioner* that an individual's management of his own investments was not a trade or business even though the individual's activities were extensive enough to require an office and staff.⁸ Congress overruled *Higgins* the following year with the enactment of the predecessor to section 212.⁹ Section 212 does not apply to corporations, suggesting that Congress thought the term "trade or business" was broad

⁴ The legislative history indicates that the primary purpose of the tax was to eliminate the "unfair" competitive advantage that tax exemption accorded exempt organizations in business activities unrelated to their exempt purposes. H.R. REP. No. 2319, 81st Cong., 2d Sess. 38-40 (1950). The meaning of the term "unfair" and the controversy over whether exempt organizations have any real competitive advantage over for-profit organizations have been the subject of lively debate. See, e.g., Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, in *The Economics of Nonprofit Institutions: Studies in Structure and Policy* 394 (S. Rose-Ackerman ed. 1986).

⁵ Section 512(a). Prior to 1950, the exemption for a charitable organization from federal income tax applied to all income of the organization, so long as the income was dedicated to charitable purposes. The majority of courts held that the destination of an organization's income, not its source, was the appropriate test for tax exemption. *Trinidad v. Sagrada Orden de Predicadores*, 263 US 578 (1924); *Sand Springs Home v. Commissioner*, 6 BTA 198 (1927). Under this so-called "destination of income" test, an organization engaged exclusively in commercial, non-exempt activities was treated as exempt from tax if all its profits were distributed to an exempt organization. See *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938); *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120, 122 (3d Cir. 1951), rev'g 14 T.C. 922 (1950).

⁶ Section 513(a).

⁷ Treas. reg. section 1.513-1(b).

⁸ 312 U.S. 212, 217 (1941).

⁹ See Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 20.1.2 (2nd ed. 1999).

enough to include investment activities of corporations.¹⁰ The Service has relied on this distinction between individuals and corporations in holding that investment activities of exempt organizations constitute a trade or business.¹¹ In general, the Service has tended to find any profit-motivated activity is a trade or business and has ignored that portion of the definition of a trade or business that refers to income arising from the sale of goods or provision of services.¹²

If the income from an investment is clearly excluded under section 512(b), it makes no difference whether the investment activity is considered a trade or business, but if the income is not of a type enumerated in section 512(b), then the trade or business issue takes on greater significance. The Service was faced with this issue in the 1970s when the tax treatment of securities lending transactions was at issue.¹³ While recognizing that it was hard to find the sale of goods or performance of services in such transactions, the Service nevertheless concluded that securities lending did constitute a trade or business.¹⁴ Subsequently, the Service reversed its position and held that securities lending is not a trade or business.¹⁵ The current view of the Service, however, appears to be that the conduct of regular and substantial investment activities constitutes a trade or business.¹⁶

2. "Passive" Income Exclusions

Certain types of income, commonly referred to as "passive income," are excluded from UBTI.¹⁷ These include dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, annuities,¹⁸ royalties,¹⁹ rents from real property and personal property leased with the real property if the rent attributable to the personal property is 50 percent or less of the total

¹⁰ Id.

¹¹ Gen. Couns. Mem. 39,615 (Mar. 23, 1987), citing *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982).

¹² Gen. Couns. Mem. 36,948 (Dec. 10, 1976); Gen. Couns. Mem. 39,615 (Mar. 23, 1987). See generally Hill & Kirschten, *Federal and State Taxation of Exempt Organizations*, para. 11.02[2][c] (1994).

¹³ For a description of a securities lending transaction, see *infra* at 12.

¹⁴ Gen. Couns. Mem. 36,948 (Dec. 10, 1976).

¹⁵ Gen. Couns. Mem. 37,313 (Nov. 7, 1977); Rev. Rul. 78-88, 1978-1 CB 163.

¹⁶ Gen. Couns. Mem. 39,615 (March 12, 1987).

¹⁷ Section 512(b). The common practice is to refer to these exceptions collectively as the "passive income exception." This practice, however, is somewhat misleading, because all of these items are excludable without regard to the active or passive nature of the activity that generated the income. But see *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1189-90 (Ct. Cl. 1981) (rental of exempt organization's mailing list was denied passive income treatment as a royalty under IRC section 512(b) because the rental was "the product of extensive business activity"), *aff'd*, 704 F.2d 1570 (Fed. Cir. 1983).

¹⁸ Section 512(a)(1).

¹⁹ Section 512(b)(2).

and the rent does not depend on income or profits derived from the leased property,²⁰ and capital gains and losses.²¹ The exclusions for dividends, interest, rents, and royalties were included when the UBTI provisions were first added to the law in 1950. The Senate Report provided:

Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because . . . they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations.²² (emphasis added)

Unfortunately, although Congress expressed an intent to exclude not only the income enumerated but also similar types of income, the language in the legislative history was not carried over to the statute. This unfortunate disparity between the legislative history and the statute has created an obstacle for the Service in dealing with investment activities and financial products that have been developed or become widely utilized since 1950. In many instances, Congress has amended the statute to include new exclusions from UBTI, including payments with respect to securities loans and gains and losses recognized on the lapse of securities options, but it has not broadened it to include all "investment income."

In 1992, the Service amended the regulations under section 512 to provide that "notional principal contracts . . . [and] other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner . . . shall be excluded in computing unrelated business taxable income."²³ Under this regulation, the Service can expand on the types of income excluded from UBTI but it implies that, at least in the Service's view, taxpayers are not entitled to exclude income on the basis of the language of the legislative history. Interestingly, the Service excluded securities lending income and income from commodities futures contracts from UBTI on the grounds that such income was similar to the type of income excluded by the statute, prior to promulgation of this regulation.²⁴ Moreover, prior to the Service's promulgation of regulations excluding income from notional principal contracts from UBTI, at least one commentator had argued that such income should be excluded from UBTI on the basis of such an argument.²⁵

B. Taxation of Unrelated Debt-Financed Income

²⁰ Section 512(b)(3).

²¹ Section 512(b)(5).

²² S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31, reprinted in 1950 U.S.C.C.A.N 3053, 3083.

²³ Treas. reg. section 1.512(b)-1(a)(1).

²⁴ Rev. Rul. 78-88, 1978-1 CB 163; Gen. Couns. Mem. 39,620 (April 3, 1987).

²⁵ See Note, Tax-Exempt Entities, Notional Principal Contracts, and the Unrelated Business Income Tax, 105 HARV. L. REV. 1266, 1276-77 (1992)

1. General Rule

The exclusions for passive income are not available for income derived from debt-financed property.²⁶ Section 514(a)(1) requires an exempt organization to include in UBTI a percentage of income derived from "debt-financed property" equal to the "average acquisition indebtedness" for the taxable year over the average amount of the adjusted basis for the taxable year. A like percentage of deductions is allowed in computing UBTI.²⁷ The straight-line method of depreciation must be used.²⁸

2. Definition of Debt-Financed Property

Debt-financed property is defined in section 514(b)(1) as any property held to produce income with respect to which there is an acquisition indebtedness at any time during the taxable year or, if the property is disposed of during the taxable year, at any time during the 12-month period ending with the disposition. The statute contains several exceptions to the definition of debt-financed property, which have the collective effect of limiting its application to investment income. Specifically, the following are excepted from the definition of debt-financed property: (a) any property substantially all the use of which is substantially related to the organization's exempt purpose;²⁹ (b) any property the income from which is included in UBTI without regard to the debt-financed property rules, except that gain from the sale or disposition of such property is not excluded under section 512(b)(5)³⁰; (c) any property to the extent income is excluded under section 512(b)(7) relating to government research, section 512(b)(8) relating to college, university, and hospital research, and section 512(b)(9) relating to fundamental research the results of which are made freely available to the public³¹; (d) any property used in any trade or business described in section 513(a)(1) relating to work performed by volunteers, section 513(a)(2) relating to convenience of members, etc., and section 513(a)(3) relating to selling of merchandise received as gifts³²; and (e) neighborhood land acquired with the intent of using it for exempt purposes within 10 years.³³

3. Definition of Acquisition Indebtedness

Acquisition indebtedness is defined as the unpaid amount of (a) indebtedness incurred by the organization in acquiring or improving debt-financed property; (b) indebtedness incurred before the acquisition or improvement of the debt-financed

²⁶ Sections 512(b)(4); 514(a)(1).

²⁷ Section 514(a)(2).

²⁸ Section 514(c)(3).

²⁹ Section 514(b)(1)(A).

³⁰ Section 514(b)(1)(B).

³¹ Section 514(b)(1)(C)

³² Section 514(b)(1)(D)

³³ Section 514(b)(3).

property if such indebtedness would not have been incurred but for such acquisition or improvement; and (c) indebtedness incurred after the acquisition or improvement of the debt-financed property if such indebtedness would not have been incurred but for such acquisition or improvement and, the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.³⁴

The statute excludes from the definition of acquisition indebtedness a number of transactions that relate to non-investment transactions common to exempt organizations. These include: (a) a 10-year exception if mortgaged property is acquired by bequest or devise and certain other conditions are met;³⁵ (b) liens for taxes and assessments that attach before the payment date;³⁶ (c) extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness;³⁷ (d) indebtedness inherent in performing an organization's exempt purpose such as indebtedness incurred by a credit union accepting deposits from its members;³⁸ (e) charitable gift annuities;³⁹ and (f) certain federal financing for low- and moderate-income persons.⁴⁰ The statute also excludes from the definition of acquisition indebtedness securities loans⁴¹ and real property acquired by pension trusts and schools, colleges, and universities.⁴² These latter two exclusions are discussed in more detail below.

If none of the statutory exceptions is applicable, then, to determine whether there is acquisition indebtedness, one must first determine whether there is indebtedness and then determine whether the indebtedness is traceable to the acquisition or improvement of income-producing property. Neither the statute nor the regulations contain a general definition of indebtedness, no doubt a reflection of the simpler investment environment that existed when the statute was enacted and the regulations promulgated. As a result, the Service and taxpayers must rely on common law definitions.⁴³

II. Securities and Other Financial Products

A. Margin Accounts

³⁴ Section 514(c).

³⁵ Section 514(c)(2)

³⁶ Section 514(c)(2)(C)

³⁷ Section 514(c)(3)

³⁸ Section 514(c)(4)

³⁹ Section 514(c)(5)

⁴⁰ Section 514(c)(6)

⁴¹ Section 514(c)(8)

⁴² Section 514(c)(9)

⁴³ See generally Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* Section 52.14 (3d ed. 2000); Mancino and Hill, *Taxation of Exempt Organizations* para. 22.03[1] (to be published by Warren, Gorham & Lamont).

For securities transactions, the "plain vanilla" example of debt-financing is a margin account and it is difficult to argue that securities bought on margin are not debt-financed. Pension funds argued that such income should not be taxed on the ground that acquiring securities on margin was inherent in their exempt function and thus excluded under section 514(c)(4), but the courts consistently rejected this argument.⁴⁴ Recently, the Second Circuit rejected a similar argument made by the Henry E. & Nancy Horton Bartels Trust⁴⁵, a supporting organization formed to provide support for the University of New Haven. The Second Circuit also rebuffed the Bartels Trust's arguments that securities bought on margin were not debt-financed because: (i) securities investment activities do not constitute a trade or business, an argument that the court found to be without relevance under the plain language of the statute;⁴⁶ (ii) neither the Bartels Trust nor any other third party gained an "unfair competitive" advantage from the investment, an argument that the court also found to be irrelevant under the plain language of the statute;⁴⁷ and, (iii) the debt-financed property rules apply only to "periodic income," an argument the court found to be without support in the legislative history or the statutory language and in direct conflict with the regulations.⁴⁸ Leveraged ESOPs have fared better than pension funds and supporting organizations. Relying on legislative history, the Service has ruled that debt-financed investments are inherent in the purpose of leveraged ESOPs.⁴⁹

Because of the "but for" test, borrowing against other assets to acquire additional securities will not avoid the reach of section 514. In *Kern County Electrical Pension Fund v. Commissioner*,⁵⁰ when interest rates fell, a pension plan acquired a new certificate of deposit with a higher interest rate, using a CD that it already held as collateral for a loan. The taxpayer didn't want to redeem the old CD because it would have incurred penalties for early withdrawal. The court held that the loan was incurred to acquire the new CD, and that interest from that CD was taxable. The taxpayer argued that in substance the issuer was paying it a higher rate of interest on its original CD.⁵¹ Similarly, withdrawal of the accumulated cash value of life insurance policies creates acquisition indebtedness with respect to securities purchased with such withdrawals.⁵² The withdrawal was viewed as indebtedness because there was an obligation to repay it. On the other hand, the Service

⁴⁴ *Elliott Knitwear Profit Sharing Plan v. Commissioner*, 614 F.2d 347 (3d Cir. 1980), affg 71 T.C. 765 (1979); *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (ND Ala. 1986); *Ocean Cove Corporation Retirement Plan v. United States*, 657 F. Supp. 776 (SD Fla. 1987).

⁴⁵ *Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*, 209 F.3d 147, 156 (2d Cir. 2000).

⁴⁶ *Id.* at 150-151

⁴⁷ *Id.* at 151-154.

⁴⁸ *Id.* at 154-155.

⁴⁹ Rev. Rul. 79-122, 1979-1 CB 204.

⁵⁰ 96 TC 845 (1991)

⁵¹ See also Gen. Couns. Mem. 37,386 (Jan 12, 1978)

⁵² *Mose & Garrison Siskind Memorial Foundation v. United States*, 790 F.2d 480 (6th Cir. 1986).

has held in a private letter ruling that transitory indebtedness incurred by a pension fund to meet deadlines for payment of pension benefits is not acquisition indebtedness where the loan is repaid in a matter of days or weeks and is de minimis.⁵³ The Service reasoned that the loan was not incurred for the purpose of acquiring investment property but, rather, for the purpose of solving a temporary cash flow problem in a de minimis amount.

B. Securities Lending Transactions

In a securities lending transaction, the owner of a security "lends" it to a broker dealer who uses the security to close a short sale. The broker dealer pays the "lender" the equivalent of any dividends that are paid while the securities are on loan, puts up collateral (normally in the form of Treasury securities) and pays the lender a premium, either in the form of a stated amount or by allowing the lender to keep income earned on the collateral during the loan period. Initially, the Service took the position that securities-lending was a trade or business and that interest and dividend equivalents paid to the lending organization were UBTI.⁵⁴ The Service later ruled that income from securities lending transactions was income from an ordinary and routine investment activity intended to be excluded from UBTI, citing the legislative history to the statutory exclusion for income earned on the lapse of an option.⁵⁵ Shortly thereafter, Congress added section 514(c)(8) to the code,⁵⁶ providing that payments with respect to securities loans (as defined in section 512(a)(5)) shall be deemed to be derived from the securities loaned and not from collateral security or the investment of collateral security from such loans, suggesting that the Service's reversal of its position may have been the result of pressure to reach a result favorable to the taxpayer. Similarly, any deductions that are directly connected with collateral security for a securities loan, or with the investment of collateral security, are deemed to be deductions that are directly connected with the securities loaned. Finally, an obligation to return collateral security is not treated as acquisition indebtedness.

C. Short Sales of Stock

A short sale of stock is the flip side of a securities lending transaction. Investors sell stock short when they think the price of the stock will fall. In a short sale of publicly traded stock, the investor sells stock that it does not own at the time of the sale, but borrows through its broker from a lender pursuant to an agreement requiring it to return the stock at a later date. The broker holds the proceeds from the sale and any income earned on the proceeds, as collateral for the investor's obligation to deliver stock identical to that which was borrowed so that it can be returned to the lender. In addition, the broker requires the investor to put up additional collateral in cash or government securities (which are not borrowed), typically equal to 50 percent of the proceeds from the

⁵³ PLR 8721107 (Feb 27, 1987). See also PLR 9644063 (Nov. 1, 1996); PLR 200010061 (Dec. 17, 1999).

⁵⁴ Gen. Couns. Mem. 36948 (Dec. 10, 1976).

⁵⁵ Rev. Rul. 78-88, 1978-1 CB 163.

⁵⁶ Pub. L. No. 95-345, section 2(e).

sale. If the price of the stock goes up, the investor may be required to post additional collateral, and part of the collateral may be returned to the investor if the price of the stock falls. A portion of the income earned on the collateral is credited to the investor, with the balance being paid to the lender and the broker. Later, the investor buys stock to deliver to close the short sale. If the investor was correct that the price of the stock would fall, it will have a gain equal to the difference between the proceeds from the sale and the price it pays for the stock it uses to close the short sale.

Relying on *Deputy v. du Pont*⁵⁷ where the Supreme Court held that a short sale created an obligation but did not create an indebtedness for purposes of section 163, the Service held that neither the gain attributable to the decline in the price of the stock or the income derived from the proceeds of the short sale held as collateral by the broker constituted acquisition indebtedness.⁵⁸ It is not clear why the Service did not publish a ruling on short sales until 17 years after publication of its ruling on securities lending transactions. The absence of a published ruling and anecdotal evidence that the Service would not issue private letter rulings approving short sales is said to have effectively prevented many exempt organizations from engaging in this relatively routine investment transaction.⁵⁹

D. Commodities Futures Transactions

A commodities futures contract is an executory contract to purchase or sell a specified quantity of an identified commodity at a future date for an agreed price. A contract to purchase is a long contract or position, and a contract to sell is a short contract or position. The holder of a futures contract is required to post margin to guarantee future performance when he enters into the contract. Most futures contracts are closed out prior to the delivery date by acquiring an offsetting obligation (i.e., acquiring a short position offsets a long position) and either paying or collecting the difference in price, depending upon the direction of the market and the original position held.

In General Counsel Memorandum 39620,⁶⁰ the Service concluded that gains and losses from commodity futures contracts are excluded from UBTI under section 512(b)(5). As it had done in its ruling on securities lending transactions, the Service relied on the statement in the legislative history of the Revenue Act of 1950 that certain items of income were excluded from UBTI because they are "passive" in character and not likely to result in serious competition for taxable businesses having similar income. The Service also concluded that the obligation of a holder of a long position to pay for the commodity upon delivery did not constitute indebtedness because it was an executory contract and neither the seller nor the buyer actually held the property at the time of entering into the

⁵⁷ 308 U.S. 488, 497-98 (1940).

⁵⁸ Rev. Rul. 95-8, 1995-1 CB 107. See also PLR 9637053 (Sept. 13, 1996); PLR 9703027 (Jan. 17, 1997).

⁵⁹ See Weigel, *supra* note 2, at 627.

⁶⁰ (April 3, 1987).

contract. The purchase of a long futures contract entailed no borrowing of money in the traditional sense. Similarly, the Service found a short contract was merely an executory contract because there was no property held by the short seller that produced income and thus there could be no acquisition indebtedness. The GCM restricted its holding to regulated futures contracts and cases where the margin deposit was paid out of the holder's own funds and was not borrowed.

E. Securities Arbitrage Transactions

In General Counsel Memorandum 39615,⁶¹ the Service considered the tax treatment of a stock index arbitrage program conducted by a private foundation. The investment strategy took advantage of the differential between the value of a stock index futures contract and the value of the stocks comprising the index. On the settlement date, the price of a stock index futures contract will equal the price of the stocks comprising the index. Before that date, there will be small price differences between the two figures, which reflect the economic difference between purchasing the underlying stocks for cash at the outset versus acquiring a long index futures contract with a 3-percent margin deposit and investing the balance of the cash in short-term government securities maturing on the contract settlement date. In theory, the price differential should equal the difference between the expected dividend yield on the stocks and the expected return on the short-term government securities, but in practice the futures contract may be overvalued or undervalued. If the futures contract was undervalued, the foundation would sell stock from its portfolio in proportions mirroring the stock index and simultaneously acquire a long futures contract for an equivalent position. If the futures contract was overvalued, the foundation would sell the futures contract and acquire the stock with borrowed funds. Because the yield differential could be determined with reasonable certainty, this strategy improved the foundation's return on its investment portfolio with little increase in risk.

The Service held that the investment activity constituted an unrelated trade or business, but that gains on disposition of the stock and futures contracts would be excluded from UBTI under section 512(b)(5) unless debt-financed. Where the futures contract was initially undervalued, the Service found there was no debt-financed property because the stock was sold, not acquired, and the margin deposits with respect to the long futures contracts did not constitute acquisition indebtedness but were merely security for performance. Where the futures contract was initially overvalued and stock was bought with borrowed funds, the Service held that the gain on disposition of the stock was debt-financed income. It also held that, because the acquisition of the debt-financed stock and the sale of the futures contract were simultaneous, the loss on the short futures contract was deductible under section 514(a)(2). Consequently, the foundation was taxable only on the net gain, not the entire gain from the sale of the stock. If the foundation had a loss on the stock, the Service had more difficulty integrating the two parts of the transaction because the offsetting gain on the futures contract could not be treated as a directly

⁶¹ (March 23, 1987).

connected deduction under section 514(a)(2). Nevertheless, recognizing that allowing the full loss on the sale of stock while excluding the gain from the futures contract under section 512(b)(5) would create an opportunity for tax abuse, the Service held that only the net loss would be deductible. It reasoned that the general scheme of the debt-financed property rules was to restore to UBTI otherwise excludable income if it was debt-financed and, that this purpose would be thwarted if the two parts of the arbitrage transaction were not offset against each other before allowing a deduction.

F. Notional Principal Contracts

Treasury regulations define a notional principal contract as "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."⁶² Typical examples include interest rate swaps, currency swaps, and equity index swaps. In a simple interest rate swap, one party (the "Fixed Rate Payor") agrees to make periodic fixed payments to a second party (the "Floating Rate Payor") who promises to make periodic payments to the Fixed Rate Payor that vary based on a standard market interest rate, such as the prime rate. The payments are calculated based on a notional principal amount, but no transfer of principal actually occurs. Reasons for entering into interest rate swaps include obtaining access to capital at more favorable interest rates than those that would otherwise be available to a party, hedging against fluctuations in interest rates, and speculating in interest rate movements.⁶³

Notional principal contracts had the potential to spawn a deluge of ruling requests and confusion in the law for years.⁶⁴ Fortunately, the Service issued regulations specifying that all income and gain from notional principal contracts are excluded from UBTI.⁶⁵ For these purposes, notional principal contracts are defined by reference to Treas. reg. sections 1.863-7 and 1.446-3. The exclusion applies without regard to the exempt organization's purpose for entering into the notional principal contract.

G. Summary

Although the debt-financed property rules have been applied to personal property such as securities and other financial products where there is actually a borrowing of funds

⁶² Treas. reg. section 1.446-3(c)(1)(i).

⁶³ For a more detailed description of the use of interest rate swaps and a description of the use of equity index swaps, see Note, *supra*, note 25. For a general discussion of the tax treatment of notional principal contracts, see Andrea S. Kramer, *Financial Products: Taxation, Regulation, and Design* (3d ed. 2000).

⁶⁴ See the discussion in Note, *supra* note 25; Thomas J. Gallagher, *When Is a Business Not a Business? Exploiting Business Opportunities and Enhancing Economic Returns By Capitalizing on the Income Tax Exemption of Tax-Exempt Organizations*, 75 *TAXES* 928-957 (1997).

⁶⁵ Treas. reg. section 1.512(b)-1(a)(1).

to make an acquisition in the traditional sense, other securities transactions have not been treated as debt-financed. The Service has struggled, however, to reach these results. In the case of securities lending transactions and commodities futures contracts, the Service relied on the legislative history of the passive income exclusions, finding that these were passive investments of the type Congress intended to exclude from tax. With securities arbitrage transactions, the Service found debt-financed income where there was a purchase of stock with borrowed funds, but stretched to net the two sides of the transactions. It had a fairly easy time concluding that short sales were not debt-financed, but did not publish a revenue ruling on the issue until 1995, leaving many exempt organizations in a position of uncertainty prior to that date. Finally, the Service has turned to its regulatory authority to deal with new financial products, issuing regulations that exclude income from notional principal contracts from UBTI and income from passive investments designated by the Service.⁶⁶ It remains to be seen whether the Service will use this new regulatory authority liberally.

III. Real Estate Exception for Qualified Organizations

Section 514(c)(9) provides an exception from the debt-financed property rule for the acquisition and improvement of real property for qualified organizations that meet certain requirements. With respect to real estate investments, the application of the debt-financed property rules has been relatively straightforward, and the focal point has been on this exception rather than the rule.

A. Qualified Organizations

A qualified organization is: (a) an educational organization described in section 170(b)(1)(A)(ii) and its affiliated support organizations described in section 509(a)(3); (b) a qualified trust under section 401 (hereinafter referred to as "pensions, "pension plans" or "pension funds"); (c) and a title holding company exempt under section 501(c)(25), but only with respect to the shares of qualified organizations as defined in (a) and (b) in the title holding company.⁶⁷

B. Requirements Applicable to All Real Estate Investments

To qualify for the real estate exception, all investments in real estate by qualified organizations must meet the following requirements:

⁶⁶ One commentator has noted that, if the Service was correct in Rev. Rul. 78-88, in relying on language in the legislative history to the effect that certain kinds of investment activity were intended to be excluded from UBTI, to exclude securities lending transactions from classification as UBTI, it may have overreached in providing in the regulation that only investments designated by the Service may be excluded as passive investments. See Gallagher, *supra* note 64, at 941.

⁶⁷ Sections 514(c)(9)(C), (F).

(1) Fixed price restriction. The price must be a fixed amount determined as of the date of the acquisition of the real property or the completion of the improvement of the real property, unless the sale is a qualifying sale by a financial institution.⁶⁸

(2) Participating loan restrictions. The amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, cannot be dependent, in whole or in part, upon any revenue, income, or profits derived from such real property, unless the sale is a qualifying sale by a financial institution.⁶⁹

(3) Sale and leaseback restrictions. The real property cannot at any time after the acquisition be leased back by the qualified organization to the seller of the property or to a party related to the qualified organization (as described in section 267(b) or 707(b)).⁷⁰

(4) Sale and leaseback restrictions -- pensions. In the case of pension plans, the real property cannot be acquired from, or leased back to, a related party (as described in sections 4975(e)(2)(C), (E)-(I)).⁷¹

(5) Seller financing restriction. The seller or a related person to the qualified organization cannot provide the qualified organization with financing for the acquisition or improvement of the real property unless the financing is on commercially reasonable terms.⁷²

C. Requirements Applicable to Investments by a Partnership

When a qualified organization holds an interest in a partnership that acquires or improves real estate, the partnership must meet the five requirements described above plus one of the following three requirements:⁷³

(1) All Qualified Organizations. All the partners of the partnership must be qualified organizations. For these purposes, an organization is not treated as a qualified organization if any income of the organization is UBTI. Few partnerships can meet this test as it is common for a taxable person to sponsor a real estate investment partnership and to serve as general partner.

(2) Qualified Allocation Rule. Each allocation to a partner that is a qualified organization must be a qualified allocation within the meaning of section 168(h)(6). Two requirements must be met for an allocation to be a qualified allocation. First, each

⁶⁸ Section 514(c)(9)(B)(i).

⁶⁹ Section 514(c)(9)(B)(ii).

⁷⁰ Section 514(c)(9)(B)(iii).

⁷¹ Section 514(c)(9)(B)(iv).

⁷² Section 514(c)(9)(B)(v).

⁷³ Section 514(c)(9)(B)(vi).

qualified organization must be allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis, and each share must remain the same during the entire period that the qualified organization is a partner in the partnership.⁷⁴ Second, each allocation must have substantial economic effect under section 704(b)(2).⁷⁵ For this purpose, contributed property allocated under section 704(c) is not taken into account.⁷⁶ Few partnerships can meet this test as it is industry practice in real estate transactions to distinguish between partners based on factors such as whether they provide services or are a substantial investor.

(3) Disproportionate Allocation Rule. The partnership must meet the two requirements of section 514(c)(9)(E). The first requirement -- referred to as the "Fractions Rule" -- is that the "allocation of items to any partner which is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest."⁷⁷ The second requirement of the Disproportionate Allocation Rule is that, as with the Qualified Allocation Rule, each allocation must have substantial economic effect under section 704(b)(2), and allocations of contributed property under section 704(c) are not taken into account.⁷⁸ Because few partnerships can meet the first two rules, most are forced to grapple with the Disproportionate Allocation Rule.

For purposes of applying the Fractions Rule, Treasury regulations permit a partnership to exclude permanently seven types of allocations: (i) reasonable guaranteed payments; (ii) reasonable preferred returns; (iii) disproportionate charge backs; (iv) certain minimum gain charge backs; (v) qualified income offsets; (vi) certain specified partner specific items of deduction and loss; and (vii) unlikely events.⁷⁹ Four other types of allocations may be excluded until actually made: (i) partner nonrecourse deductions; (ii) minimum gain charge backs attributable to distributions of nonrecourse debt proceeds; (iii) deficit capital account balance allocations; and (iv) changes in partners' interests.⁸⁰ Special rules are provided for applying the Fractions Rule to tiered partnerships.⁸¹

IV. Choice of Investment Vehicle

⁷⁴ Section 168(h)(6)(B)(i).

⁷⁵ Section 168(h)(6)(B)(ii).

⁷⁶ Section 168(h)(6)(B).

⁷⁷ Section 514(c)(9)(E)(i)(I).

⁷⁸ Section 514(c)(9)(E)(i)(II).

⁷⁹ Treas. reg. sections 1.514(c)-2(c) through (g).

⁸⁰ Treas. reg. sections 1.514(c)-2(b)(2), (j), and (k).

⁸¹ Treas. reg. section 1.514(c)-2(m). For a more detailed description of the rules described in the paragraph accompanying this footnote, see Holloway, "Structuring Real Estate Investment Partnerships With Tax-Exempt Investors," *Tax Notes Today* (June 13, 2000).

Investors have a bewildering array of investment vehicles available to them. For exempt organizations, the decision whether to invest in property directly or through an investment vehicle, and the choice of investment vehicle, can make the difference between a tax-exempt and a taxable investment. This section of the paper highlights some of the key differences.

A. Direct Investment

A qualified organization can avoid UBTI and the complicated rules of section 514(c)(9)(B)(vi) that apply to partnership investments if it invests in real estate directly rather than through a partnership. Investment through a partnership is often viewed as preferable, however, because it offers the opportunity to invest in larger properties and because the general partner is usually experienced in day-to-day management of real estate properties. Another drawback of a direct investment is that the exempt organization's assets may be exposed to liability.

B. Pass-Through Entities

1. Partnerships

Under section 512(c)(1), an exempt organization is subject to tax on any trade or business carried on by a partnership if the trade or business is an unrelated trade or business with respect to the exempt organization. It is irrelevant whether the exempt organization is a general or limited partner⁸² and, for years beginning after January 1, 1994, it is irrelevant whether the partnership is publicly traded.⁸³ For real estate investments by qualified organizations, the partnership must comply with the rules of section 514(c)(9) in order for the exempt organization partners to avoid taxation. As noted above, that means complying with the Fractions Rule. Investments through partnerships may also expose exempt organizations to liability. As noted below, title holding companies do not provide a solution because section 501(c)(2) title holding companies do not qualify for the real estate exception of section 514(c)(9) and section 501(c)(25) title holding companies cannot invest in partnerships.

2. Limited Liability Companies (LLCs)

LLCs provide limited liability and can invest in a partnership while a section 501(c)(25) organization cannot. A single member LLC is disregarded for federal tax purposes so there is no need to acquire tax-exempt status as is necessary for a section 501(c)(2) or 501(c)(25) title holding company. In some states, however, an LLC is taxed as a corporation.⁸⁴

⁸² Rev. Rul. 79-222, 1972-2 C.B. 236.

⁸³ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, section 13145(a)(1)-(3).

⁸⁴ See, e.g., Texas Tax Code section 171.001(b)(3)(A),

3. Real Estate Investment Trusts (REITs)

Generally, investment in debt-financed property through a REIT does not result in UBTI for exempt organizations. By definition, however, a REIT must have 100 or more shareholders,⁸⁵ a requirement that makes it difficult for any single shareholder to exercise much control over investment decisions. Moreover, section 856(h)(3)(C) provides for recharacterizing a portion of dividends received from REITs to the extent that their income would be UBTI, if the REIT is "predominantly held by qualified trusts." A REIT is predominantly held by qualified trusts if (a) at least one qualified trust holds at least a 25-percent interest in the REIT or (b) one or more qualified trusts, each of which holds more than a 10-percent interest in the REIT, collectively hold more than 50 percent of the interests in the REIT.⁸⁶ Thus, the rules adopt a look-through approach for UBTI if one or a small group of qualified trusts own sufficient interests to direct the activities of the REIT. Further, a prohibition against REITs being closely held generally would prevent exempt organizations described in section 501(c) from controlling a REIT. Generally, under the closely held prohibition, more than 50 percent of the REIT cannot be held by five or fewer shareholders.⁸⁷

4. Section 584 Common Trust Funds

The debt-financed character of property held by a common trust fund maintained by a bank is passed through to the beneficiaries and taxed as UBTI.⁸⁸ Prior to amendment of the section 584 regulations in 1996, exempt organizations that pooled assets in a common trust fund did not have debt-financed income from property acquired by the fund with debt.⁸⁹

5. Section 501(f) Funds

An organization that is organized and operated to collectively invest solely in stocks and securities, to pay over all the income to the members, and whose members consist solely of educational organizations described in section 170(b)(1)(A)(ii) is exempt from tax under section 501(f). There are no regulations under section 501(f) but, since the code

enacted by the Tax Revision and Reform Act of 1999, Ch. 406.

⁸⁵ Section 856(c)(5).

⁸⁶ Section 856(h)(3)(D)(ii).

⁸⁷ Section 856(h).

⁸⁸ Treas. reg. section 1.584-2(c)(4)(vi), as amended by T.D. 8662, 61 Fed. Reg. 19546 (May 2, 1996).

⁸⁹ PLR 8230024 (May 18, 1982).

treats these funds as organizations organized and operated exclusively for charitable purposes, they presumably would be taxed on debt-financed income.

C. Corporate Entities

1. Section 501(c)(2) Title Holding Companies

Section 501(c)(2) title holding companies have been exempt since 1916. Such organizations can only have one shareholder.⁹⁰ They must restrict their activity to holding title to property and turning the income over to the parent. They are not restricted in the types of investments they can make,⁹¹ but UBTI is allowed only if it arises from debt-financing or is incidental to the holding of the property. A section 501(c)(2) title holding company is not a qualified organization for purposes of the real estate exception of section 514(c)(9) and qualified organizations lose the benefit of section 514(c)(9) if they make a debt-financed real estate investment through a section 501(c)(2) title holding company.⁹² The effect of this rule may be mitigated by Rev. Rul. 77-71, 1977-1 CB 155. In that ruling, the Service held that a mortgage loan from a tax-exempt labor union to its section 501(c)(2) holding company to finance the title holding company's acquisition of real property was not acquisition indebtedness. The Service treated the parent and subsidiary as a single economic unit, even though they are treated as separate entities for tax and corporate law purposes.

2. Section 501(c)(25) Title Holding Companies

Section 501(c)(25) was added to the code in 1986. To be exempt, these organizations must be organized for the exclusive purpose of acquiring and holding real property and remitting the income to one or more specified groups of tax-exempt organizations that are its shareholders or beneficiaries. They cannot have more than 35 shareholders or beneficiaries and can have only one class of stock or beneficial interest. They must invest directly in real property and cannot invest in a partnership or undivided fee interest. Qualified organizations that invest in section 501(c)(25) organizations get the benefit of the real estate exception of section 514(c)(9), but other organizations do not. A section 501(c)(25) organization can have a de minimis amount of UBTI, so long as it is incidental to the ownership and operation of the real property held by the organization.

3. Foreign Corporations

⁹⁰ Gen. Couns. Mem. 37,351 (Dec. 20, 1977).

⁹¹ Rev. Rul. 66-295, 1966-2 C.B. 207.

⁹² PLR 8326173 (April 5, 1983) (Service rejected pension plan's argument that it had a principal-agent relationship with the title holding company it had formed to invest in real estate).

A tax-exempt organization can avoid the impact of the debt-financed property rules by investing in debt-financed property through a foreign corporation. In Private Letter Ruling 9952086, an exempt organization held 100 percent of the stock in a foreign corporation that invested in a U.S. partnership holding debt-financed securities. The Service held that the dividends paid by the foreign corporation to the exempt organization were excluded from UBTI as dividends under section 512(b)(2) and were not debt-financed income because the exempt organization had not incurred debt to acquire its interest in the foreign corporation. This result is essentially the same result that the Service reached with respect to offshore captive insurance companies,⁹³ which was reversed by the addition of section 512(b)(17)(A) to the code, providing that foreign source income is UBTI.⁹⁴

4. S Corporations

Section 512(e)(1) provides that the distributive share of income or loss from an S Corporation is treated as UBTI without regard to the nature of the underlying income. Thus, even investment income that is not debt-financed is taxable to exempt organizations if derived from property held by an S Corporation in which the exempt organization holds stock.

V. Legislative History⁹⁵

The legislative history of the debt-financed property rules consists of two distinct phases. From 1950 through 1969, Congress sought to foreclose sale-leaseback transactions, beginning with narrow provisions directed at specific transactions and passing progressively broader provisions in response to new transactions that skirted its narrow targeted provisions, ending with the passage of the broad rule taxing all debt-financed income. From 1980 to the present, in response to pleas from taxpayers, Congress has carved exceptions to the broad statute it passed in 1969 and, in response to pleas from Treasury, has enacted a complex set of conditions for many of those exceptions.

A. 1950-1969: Expanding Efforts to Foreclose Abusive Sale-Leaseback Transactions

The predecessor of today's debt-financed property rules was enacted as part of the first UBIT provisions in 1950. Although an exclusion for passive income was included in the UBIT provisions, the exclusion did not include certain rents on property acquired with

⁹³ PLR 8819034 (Feb. 10, 1988)

⁹⁴ Small Business Job Protection Act of 1996, Pub. L. 104-188, section 1603(a).

⁹⁵ Much of this section is drawn from a previous paper published by the author, *Taxing Leveraged Investments of Charitable Organizations: What is the Rationale?*, 39 CASE W. RES. L. REV. 705 (1989).

borrowed funds.⁹⁶ These rents were subjected to tax in an effort to prevent certain sale and lease-back transactions.⁹⁷ In such transactions, a charitable organization would acquire a property (such as real estate) from a taxable business, often borrowing to finance the entire purchase price.⁹⁸ As a condition of the sale, the exempt organization would lease the property back to the seller on a long-term basis.⁹⁹ The exempt organization would repay the loan, plus interest, with the "rental" received from the seller-lessee.¹⁰⁰ As a result, the exempt organization, while investing and risking little or none of its own funds, obtained the difference between the "rental" payments and the sale price, and eventually secured title to the property outright.¹⁰¹ The seller treated the sale price as a capital gain, and continued to operate the business, using the "rental" payments as large deductions against the company's taxable income.

Congress identified three principal problems with sale and lease-back arrangements where borrowed funds were used. First, the exempt organization was "trading on its exemption, since the only contribution it [made] to the sale and lease-back was its tax exemption."¹⁰² Second, because exempt organizations could acquire property through lease-backs without investing any of their own funds, exempt organizations could conceivably come to "own the great bulk of the commercial and industrial real estate in the country," resulting in a serious erosion of the corporate and individual income tax base.¹⁰³ Third, the exempt organization may have "sold" part of its exemption, either by paying a higher price for the property or by charging lower rents than a taxable business.¹⁰⁴

In response to these three problems, Congress imposed the unrelated business income tax on rentals from leases of real property (and personal property leased in connection with it) if the term of the lease exceeded five years (taking into account options to renew)¹⁰⁵ and borrowed funds were used to acquire or improve the realty.¹⁰⁶ As in

⁹⁶ Revenue Act of 1950, ch. 994, section 301(a), 64 Stat. 906, 949 (amending IRC section 422(a)(4) as it then existed) (currently codified at IRC section 512(b)(4) (1986)).

⁹⁷ S. REP. No. 2375, 81st Cong., 2d Sess. 31-33, reprinted in 1950 U.S.C.C.A.N. 3053, 3083-85.

⁹⁸ *Id.* at 31, reprinted in 1950 U.S.C.C.A.N. at 3083.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.* at 31, reprinted in 1950 U.S.C.C.A.N. at 3084; H.R. REP. No. 2319, 81st Cong., 2d Sess. 38 (1950).

¹⁰³ S. REP. No. 2375, 81st Cong., 2d Sess. 30-31, reprinted in 1950 U.S.C.C.A.N. 3053, 3084.

¹⁰⁴ *Id.* See also Note, Taxation of Sale and Lease-Back Transactions, 60 YALE L.J. 879, 880 (1951) (analyzing non-tax consequences of sale and lease-back transactions); *id.* at 888 (unfair competition exists even if the property is not debt-financed). Cf. Hall, The Clay Brown Case and Related Problems, in U. SO. CAL. 18TH TAX INST. 337 (1966) (questioning whether exempt organizations really were paying more than fair market value). Even if the Hall article is correct in arguing that exempt organizations paid no more than fair market value, the situation remains troublesome. As a matter of theory, exempt organizations would have the capability of delivering a price above fair market value, an option unavailable to for-profit organizations.

¹⁰⁵ Revenue Act of 1950, ch. 994, section 301(a), 64 Stat.

current law, the tax was imposed on a fraction of the rentals equal to the amount of outstanding indebtedness divided by the adjusted basis of the property at the close of the taxable year¹⁰⁷ less deductions for taxes and other expenses that were allowed on the same pro rata basis.¹⁰⁸ Exceptions were provided for leases entered into for purposes "substantially related" to the basis for the organization's exemption and to leases of premises "primarily designed for occupancy, and occupied, by the organization."¹⁰⁹

It did not take long for tax professionals to develop transactions that achieved the same purposes as the sale-leaseback transactions, but fell outside the reach of the business lease provision. After 1950, the arrangements were structured typically as three-party transactions.¹¹⁰ Shareholders of a taxable corporation (usually closely held) would sell their stock to a charitable organization. The charity would pay for the stock with little or no down payment and a nonrecourse promissory note. The charity would then dissolve the corporation and lease its assets for a five-year term to a newly formed corporation, which was usually owned by associates of the former shareholders. The new corporation would pay a large percentage of its profits as "rent" to the tax-exempt entity, which would then turn over most of those payments to the former shareholders as installment payments on the promissory note.¹¹¹

The 1950 legislation was ineffective against these transactions. The selling shareholders were able to treat payments on the promissory note as capital gain, the new corporation was able to deduct the large "rent" payments, and the tax-exempt entity received a portion of the new company's profits tax-free.¹¹² The parties avoided the tax imposed on rental income by the 1950 legislation by merely negotiating leases with a term of five years or less.¹¹³ In addition, payments made by the new corporations for the lease of personal property in connection with real property were treated as excludable "rent" when received by the exempt organization, even if the real estate in question comprised only a small fraction of the assets leased.¹¹⁴

906, 950 (amending IRC section 423(a) as it then existed).

¹⁰⁶ Id. section 301(a), 64 Stat. 951-52 (amending IRC section 23(b) as it then existed).

¹⁰⁷ Id. section 301(a), 64 Stat. 952 (amending IRC section 23(d)(1) as it then existed).

¹⁰⁸ Id. (amending IRC section 423(d)(2) as it then existed).

¹⁰⁹ Id. section 301(a), 64 Stat. 950 (amending IRC section 423(a) as it then existed).

¹¹⁰ See *Commissioner v. Brown*, 380 U.S. 563, 566 (1965) (the leading case involving a three-party transaction); Beller, *Exempt Organizations: Taxation of Debt-Financed Income*, 24 *TAX LAW* 489, 490-92 (1971).

¹¹¹ Beller, *supra* note 110, at 491.

¹¹² Id. at 489, 491.

¹¹³ See Revenue Act of 1950, ch. 994, section 301(a), 64 Stat. 906, 950.

¹¹⁴ See *University Hill Found. v. Commissioner*, 51 T.C. 548, 570-71 (1969) (foundation not required to pay income and excess profit taxes), *rev'd*, 446 F.2d 701 (9th Cir. 1971) (foundation must pay tax on rental received from personal property leased along with the real property), *cert. denied*, 405 U.S. 965 (1972).

The Service's efforts to attack these transactions through administrative pronouncements and litigation were unsuccessful. The Service issued an initial ruling that addressed the effect of these transactions on exempt organizations.¹¹⁵ The ruling stated that a foundation engaging in a three-way transaction such as the one described above would not be considered to be "engaged exclusively in activities coming within the contemplation of section 101(6) of the code" (current section 501(c)(3)).¹¹⁶ In addition, the IRS cautioned that such income would not fall within the exception to the unrelated business taxable income rules for rent.¹¹⁷ Finally, the ruling suggested that tax-exempt organizations that entered these three-way transactions would expose themselves to a charge of unreasonable accumulation of income under the predecessor to section 4943.¹¹⁸

In the courts, the Service unsuccessfully attacked the capital gain treatment claimed by the original corporation on the sale of the property¹¹⁹ and the rental deductions claimed by the new corporation.¹²⁰ The Supreme Court ultimately decided the capital gain issue in *Clay Brown*.¹²¹ In that case, the stock of a small lumber company in California was sold to a tax-exempt foundation for a small down payment and a promissory note.¹²² The company was liquidated and the assets leased for a five-year term to a new company, which paid 80 percent of its profits to the foundation as "rent."¹²³ The foundation then paid 90 percent of the "rent" to the former shareholders under the terms of the promissory note.¹²⁴ When the former shareholders characterized the payments as capital gain, the IRS objected.¹²⁵ Justice White, writing for a majority of the Court, sided with the shareholders. He concluded that the foundation's lack of business risk in the transaction had no bearing on the issue of whether it legally constituted a "sale" for purposes of capital gain treatment.¹²⁶

Following *Clay Brown* and a similar decision in *University Hill Foundation v. Commissioner*,¹²⁷ Congress passed legislation as part of the Tax Reform Act of 1969 that taxed income from all debt-financed property (including tangible personal property and business assets) if the property was unrelated to the organization's exempt function. As

¹¹⁵ Rev. Rul. 54-420, 1954-2 C.B. 128.

¹¹⁶ *Id.* at 130.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Estate of Hawley*, 20 T.C.M. (CCH) 210 (1961) (capital gains treatment allowed); *Union Bank v. United States*, 285 F.2d 126 (Ct. Cl. 1961) (profits received as a result of sale granted capital gains treatment).

¹²⁰ E.g., *Brekke v. Commissioner*, 25 T.C.M. (CCH) 1063 (1966) (amounts paid were deductible as rent).

¹²¹ *Commissioner v. Brown*, 380 U.S. 563 (1965).

¹²² *Id.* at 567.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.* at 568.

¹²⁶ *Id.* at 570.

¹²⁷ 446 F.2d 701 (9th Cir. 1971), rev'g 51 T.C. 548 (1969), cert. denied, 405 U.S. 965 (1972).

with the 1950 legislation, the tax on the income from such property was dependent upon the relationship between the amount of indebtedness and the adjusted basis of the property financed.¹²⁸ The exception for short-term leases was eliminated.¹²⁹ In the committee reports, Congress cited the Clay Brown transaction as the reason for the legislation.¹³⁰

B. 1980 to 1993: Carving Exceptions to the Debt- Financed Property Rules

1. 1980: Exception for Real Estate Investments for Pensions

In 1980, Congress enacted an exception to the debt-financed property rules for certain real estate investments of qualified pension trusts.¹³¹ Proponents of the exception made two arguments. First, they claimed that the debt-financed property rules did not apply to pension plan investments in bank common trust funds¹³² and life insurance company segregated asset accounts,¹³³ and as a consequence, the tax law created a competitive imbalance among financial intermediaries offering investment services to qualified pension plans.¹³⁴ Second, they argued that because of inflation, there was a need to facilitate real estate investments by qualified pension trusts.¹³⁵

In testimony before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, the Treasury Department rejected each of the proponents' arguments. The first argument was rejected because Treasury thought that as a matter of policy the income of common trust funds should retain its character in the hands of its participants.¹³⁶ The second was rejected because debt-financing is not an essential, but only a conventional, method of acquiring real estate.¹³⁷

¹²⁸ Tax Reform Act of 1969, Pub. L. No. 91-172, section 121(d), 83 Stat. 487, 543-48 (current version at IRC section 514 (1986)).

¹²⁹ *Id.*

¹³⁰ S. Rep. No. 552, 91st Cong., 1st Sess. 62-63, reprinted in 1969 U.S.C.C.A.N. 2027, 2091-92; H.R. REP. No. 413, 91st Cong., 1st Sess. 44-46, reprinted in 1969 U.S.C.C.A.N. 1645, 1690-91.

¹³¹ Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, section 110, 94 Stat. 3521, 3525-26 (codified as amended at IRC section 514 (1986)).

¹³² Five Misc. Tax Bills: Hearings on S. 650 Before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm., 96th Cong., 2d Sess. 295 (1980) [hereinafter Five Misc. Tax Bills] (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury).

¹³³ *Id.* at 295. This position is reflected in IRC section 801 (1986).

¹³⁴ *Id.*

¹³⁵ *Id.* at 295-96.

¹³⁶ *Id.* at 295. The regulations under section 584 were subsequently amended to provide that the debt-financed character of property held by a common trust fund "passed through" to the fund's beneficiaries. See Treas. reg. section 1.584-2(c)(4)(vi) (as amended in 1984). In 1984, Congress gave the Treasury regulatory authority to prevent the circumvention of section 514 through segregated asset accounts, but no regulations have yet been promulgated. See Tax Reform Act of 1984, Pub. L. No. 98-369, section 1034(b), 98 Stat. 494, 1040.

¹³⁷ Five Misc. Tax Bills, *supra* note 132, at 296.

Notwithstanding its reservations, Treasury did not oppose the exception enacted in 1980. Because of the substantial tax benefits available to taxable investors in real estate, Treasury concluded that exempt investors were not likely to have an advantage over taxable investors if they were exempt from tax on debt-financed real estate investments.¹³⁸ Further, Treasury concluded that an exception limited to pension funds could be justified on the ground that the exemption for investment income was the *raison d'être* of the exemption granted to pension funds, whereas the exemption for investment income was a mere "by-product" of exemptions granted to other organizations. For this reason, Treasury was "less troubled" by allowing pension funds to maximize the benefits of their exemptions than it would have been by allowing other tax-exempt organizations to do the same.¹³⁹

Although the Treasury did not oppose the exception enacted in 1980, it insisted on several safeguards in order to prevent a recurrence of the exploitation of debt-financing that existed prior to 1969. With minimal changes, Treasury's proposed safeguards were enacted and remain in the law today as the first four requirements that must be met for any real estate investment of a qualified organization to be tax-exempt under section 514(c)(9).

2. 1984: Extension of Real Estate Exception to Schools and Enactment of Partnership Rules

Following enactment of the exception for pension funds, legislation was introduced to extend the exception to schools.¹⁴⁰ Testifying on Senate bill 2498 in 1982, Treasury opposed the extension.¹⁴¹ It stated that the tax on debt-financed income was useful in preventing the creation of unintended benefits from tax-exempt status (such as the transfer of the benefit of tax exemption to taxable parties through partnerships employing special allocations).¹⁴² It defended the exception for pension funds on the grounds that the exemptions for pensions and schools have different purposes, and that the exemption for pensions results in tax deferral while the exemption for schools often results in a

¹³⁸ *Id.* at 298. In fact, exempt organizations, when subjected to tax under IRC section 514, were at a disadvantage compared to taxable entities. Exempt organizations were limited to straight line depreciation under section 514, while taxable entities could use accelerated depreciation. Thus, exempt entities could be taxed at a higher rate than taxable entities when they acquired debt-financed property.

¹³⁹ *Id.* This distinction between pension funds and other exempt organizations seems sound if the purpose of section 514 is to prevent organizations from growing from within and thereby make them dependent on donors and members. This distinction does not seem meaningful if the purpose of section 514 is to prevent transactions that are viewed as abusive.

¹⁴⁰ S. 2498, 97th Cong., 2d Sess. (1982).

¹⁴¹ 1981-82 Miscellaneous Tax Bills, XVI: Hearing on S. 2498 Before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm., 97th Cong., 2d Sess. 53 (1982) (statement of William McKee, Tax Legislative Counsel, Department of the Treasury).

¹⁴² *Id.* at 54.

permanent exemption.¹⁴³ On the other hand, the Treasury found no basis for differentiating between schools and other organizations exempt under section 501(c)(3) which would continue to be fully subject to the tax on debt-financed property, and opposed "piecemeal" repeal of the provision.¹⁴⁴

A year later, Treasury testified in opposition to a similar bill.¹⁴⁵ It emphasized the importance of section 514 as an anti-abuse provision,¹⁴⁶ and objected to the bill because it would have permitted a buyer to use nonrecourse financing provided by a seller of property so long as the financing was not subordinate to other debt on the property and the rate of interest was comparable to the market rate. Treasury believed that the bill would enable sellers to convert ordinary income to capital gain. Treasury was also concerned that the exempt organization would be able to pay an inflated price for the property based on the exempt organization's ability to receive rental income tax-free.¹⁴⁷ It stated further that the possibilities for transferring tax benefits from tax-exempt to taxable partners through partnership allocations were so varied that it was doubtful that rules could be drafted to prevent allocations of this sort.¹⁴⁸ Finally, Treasury observed that the bill would give tax-exempt educational institutions an incentive to solicit gifts of real estate tax shelters that had passed the "cross-over" point at which the taxable income exceeded the cash flow produced, thus providing further tax advantages to the taxable investors. Treasury opposed the exception for pensions and reiterated the concern that if the exception were extended to schools there would be no principled basis for denying the same exception to other section 501(c)(3) organizations, and perhaps to other tax-exempt organizations as well.¹⁴⁹ Further, it warned that expansion of the exception for investments in real estate might lead to exceptions for investments in other types of property.¹⁵⁰

Congress was unpersuaded by Treasury's strenuous objection to the piecemeal repeal of section 514, and in 1984 it extended the exception for debt-financed real

¹⁴³ *Id.* at 55. The latter difference is questionable. If a school uses its investment income to acquire goods or services from taxable persons, the income will become subject to tax in the hands of such persons. Moreover, taxation of pension income may be deferred for 40 years.

¹⁴⁴ *Id.*

¹⁴⁵ S. 1183, 98th Cong., 1st Sess. (1983). For the text of Senate bill 1183 see 5 1983-84 Misc. Tax Bills: on S. 927, S. 1183 and H.R. 2163: Hearings Before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm., 98th Cong., 1st Sess. 31-34 (1983) (statement of Robert G. Woodward, Acting Tax Legislative Counsel, Department of the Treasury) (hereinafter 1983-84 Hearings).

¹⁴⁶ 1983-84 Hearings, *supra* note 144, at 86-87.

¹⁴⁷ *Id.* at 88.

¹⁴⁸ *Id.* at 89.

¹⁴⁹ 1983-84 Hearings, *supra* note 144, at 89.

¹⁵⁰ *Id.* Later that year, a bill was introduced that provided an exception for investments in limited partnerships that used debt-financing to purchase working interests in oil and gas, but it was not enacted into law. S. 1549, 98th Cong., 1st Sess. (1983).

property to schools.¹⁵¹ Congress did, however, respond in part to Treasury's concern over potential abuses. It added two further requirements that pension funds and schools must meet in order to qualify for the exception to the debt-financed property rules. First, it added the fifth requirement applicable to all real estate investments by qualified organizations -- that no part of the financing be provided by the seller.¹⁵² Second, for investments made through partnerships, it added the first two requirements of section 514(c)(9)(vi): (i) all of the partners in the partnership must be "qualified organizations" (i.e., pension funds or schools) or (ii) each allocation to a partner which was a qualified organization must constitute a qualified allocation within the meaning of the tax-exempt leasing provisions of section 168(h)(6).¹⁵³

3. 1986 and 1988: Extension of Real Estate Exception to Section 501(c)(25) Organizations

In 1986, Congress added section 501(c)(25) to the code which granted tax-exempt status to certain real estate title holding companies,¹⁵⁴ and Congress extended to these organizations the exception from the debt-financed property rules for real property.¹⁵⁵ Congress thereby indirectly extended the exception to all organizations that could hold an interest in a section 501(c)(25) organization, including all section 501(c)(3) organizations. Stating that the pre-1986 rules made an untenable distinction between educational

¹⁵¹ Deficit Reduction Act of 1984, Pub. L. No. 98-369, section 114, 98 Stat. 494, 496 (codified at IRC section 514(c)(9)(C)(i) (1986)). A "school" is defined as an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." IRC section 170(b)(1)(A)(ii) (1986).

¹⁵² IRC section 514(c)(9)(B)(v) (1986).

¹⁵³ IRC sections 514(c)(9)(B)(vi)(I) and (II) (1986).

¹⁵⁴ Tax Reform Act of 1986, Pub. L. No. 99-514, section 1603(a), 100 Stat. 2085, 2768 (codified at IRC section 501(c) (1986)). Section 501(c)(25) provides tax-exempt status to a corporation that acquires real property and remits the entire amount of income from that property (less expenses) to one or more of the following organizations: a qualified pension, profit-sharing, or stock bonus plan that meets the requirements of IRC section 401(a); a governmental plan (within the meaning of IRC section 414(d)); the United States, any state or political subdivision thereof, or any agency or instrumentality of the foregoing; and any organization described in IRC section 501(c)(3). A section 501(c)(25) organization can have no more than 35 shareholders or beneficiaries and only one class of stock. Further, the organization's shareholders or beneficiaries must have certain specified rights over the investment advisor and the right to withdraw from the corporation or trust.

¹⁵⁵ Tax Reform Act of 1986, Pub. L. No. 99-514, section 1603(b), 100 Stat. 2085, 2768-69 (codified at IRC section 514 (1986)).

organizations and other section 501(c)(3) organizations, Treasury did not object to this extension of the exception.¹⁵⁶ It also noted that the exception's potential for creating unintended benefits had been reduced by the 1984 amendments.¹⁵⁷

The extension of the real estate exception to other section 501(c)(3) organizations through section 501(c)(25) was short-lived. Under changes made by the Technical and Miscellaneous Revenue Act of 1988, the exception now is available only to the extent that the shareholders or beneficiaries of the organization would have been treated as qualified organizations prior to the enactment of the 1986 Act.¹⁵⁸ Thus, the 1988 Act repealed the 1986 Act's extension of the section 514(c)(9) exception, and again restricted the exception to pension trusts and schools.

4. 1986 to 1988: Changes to the Partnership Requirements of the Real Estate Exception

Section 514(c)(9) was amended again by The Omnibus Budget Reconciliation Act of 1987. This Act replaced a tax avoidance test that had been added by the Tax Reform Act of 1986¹⁵⁹ with the Disproportionate Allocation Rule of Section 514(c)(9)(E). As originally enacted in 1987, a disproportionate allocation was permitted if, throughout the entire period that a qualified organization was a partner in the partnership: (a) no distributive share of overall partnership loss allocable to a partner other than a qualified organization could exceed such partner's smallest distributive share of overall partnership income for any taxable year; (b) no distributive share of overall partnership income allocable to a qualified organization could exceed such partner's smallest distributive share of overall partnership loss for any taxable year; and (c) each partnership allocation had substantial economic effect within the meaning of section 704(b).¹⁶⁰

¹⁵⁶ Miscellaneous Tax Bills, 1986: Hearing on H.R. 3301 Before the Subcomm. on Select Revenue Measures of the House Comm. On Ways and Means, 99th Cong., 2d Sess. 187, 190 (1986) (statement of Richard D'Avino, Acting Deputy Tax Legislative Counsel, Department of the Treasury).

¹⁵⁷ *Id.*

¹⁵⁸ Pub. L. No. 100-647, section 1016, 1988 U.S.C.C.A.N. (102 Stat.) at 3573-75.

¹⁵⁹ The rules added in 1986 permitted a qualified organization investing in a real estate partnership to qualify for exception, assuming it met the other requirements, if it met the "tax avoidance test." An allocation (other than a qualified allocation to a qualified organization) would fail this test if its principal purpose was the avoidance of income tax. Pub. L. No. 99-514, section 1878(e)(3), 100 Stat. 2085, 2903-04. The House Report cited as an example of a permissible allocation a partnership that elected 40-year straight-line depreciation on leased real estate but failed to meet the qualified allocation rule because an increased share of a loss or deduction was allocated to the exempt organization in order to meet the substantial economic effect requirement of section 704(b)(2). H.R. Rep. No. 426, 99th Cong., 1st Sess. 1035 (1985).

¹⁶⁰ Revenue Act of 1987, Pub. L. No. 100-203, section 10,214, 101 Stat. 1330, 1330-407 to 1330-408 (1987).

The conference report gave an example of an allocation that was prohibited by the fractions rule.¹⁶¹ In the example, a partnership that held debt-financed real property was formed by a taxable partner and a qualified organization. Overall partnership income and loss were allocated as follows:

| | Qualified Organization | Taxable Partner |
|-------------------|-------------------------------|------------------------|
| Years 1-5 | | |
| Income: | 60% | 40% |
| Loss: | 80% | 20% |
| Years 6-10 | | |
| Income: | 40% | 60% |
| Loss: | 20% | 80% |

The conference report stated that the example failed the Fractions Rule because of the mismatch between loss and income allocated to the qualified organization in various years. Specifically, the qualified organization's smallest share of loss was 20 percent, and this was exceeded by the allocation to it of 60 percent (in years one through five) and 40 percent (in years six through ten) of the overall partnership income. The largest share of income that could be allocated to the tax-exempt partner under the Fractions Rule was 20 percent. Any portion from zero to 20 percent could be allocated to it. Similarly, the largest share of loss that could be allocated to the taxable partner was 40 percent (corresponding to his smallest share of overall partnership income).

Just one year later, Congress again amended section 514(c)(9). In 1988, it deleted the limitation under the fractions rule on the share of loss that could be allocated to a partner that is not a qualified organization, but retained the limitation on the share of gain that can be allocated to a qualified organization.¹⁶² The House report explained that the objectives of the Fractions Rule -- limiting the allocation of income to qualified tax-exempt partners in excess of their smallest share of loss and limiting the allocation of loss to other partners in excess of their smallest share of income -- could be accomplished by either part of the rule standing alone.¹⁶³

In addition, Congress provided that Treasury shall prescribe regulations necessary to carry out the purpose of section 514(c)(9).¹⁶⁴ The House Report indicated that this regulatory authority was provided because the Fractions Rule of section 514(c)(9) and the substantial economic effect rule of section 704(b) lead to inconsistent outcomes in some

¹⁶¹ H.R. Rep. No. 495, 100th Cong., 1st Sess. 956, reprinted in 1987 U.S.C.C.A.N. 2313-1702.

¹⁶² Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, section 2004(h), 1988 U.S.C.C.A.N. (102 Stat.) at 3603.

¹⁶³ H.R. REP. No. 795, 100th Cong., 2d Sess. 405 (1988).

¹⁶⁴ Id. at 404.

cases.¹⁶⁵ The report directed Treasury to resolve conflicts in a manner that would carry out the congressional purpose of limiting the transfer of tax benefits from tax-exempt partners to taxable partners.¹⁶⁶ Treasury issued final regulations in 1994, but they did not address inconsistencies between the fractions rule and the substantial economic effect test.¹⁶⁷

5. 1993: Relaxation of Certain Restrictions

The Omnibus Budget Reconciliation Act of 1993¹⁶⁸ relaxed some of the restrictions that had been imposed in 1980 and 1984. Specifically, the leaseback and disqualified person restrictions were relaxed to permit a limited leaseback of debt-financed property to the seller or to a disqualified person if (a) no more than 25 percent of the leasable floor space in a building is leased back to the seller (or related party) or to the disqualified person, and (b) the lease is on commercially reasonable terms.¹⁶⁹ In addition, the restriction on seller-financing was relaxed to permit seller financing on terms that are commercially reasonable.¹⁷⁰ Finally, the fixed price and participating loan restrictions were eliminated in cases where: (a) a qualified organization acquires the real property from a financial institution that acquired the property by foreclosure or was held by the selling financial institution at the time it entered into conservatorship or receivership; (b) any gain recognized by the financial institution is ordinary income; and (c) the stated principal amount of the seller financing does not exceed the financial institution's outstanding indebtedness with respect to the property at the time of foreclosure or default; and (d) the present value of the maximum amount payable pursuant to any participation feature cannot exceed 30 percent of the total purchase price of the property.¹⁷¹

VI. Problems With the Debt-Financed Property Rules

A. Section 514 Is an Overbroad Response to Abusive Sale Leaseback Transactions

Congress's concern in the period from 1950, when it enacted the narrow business lease rule, to 1969, when it enacted the unrelated debt-financed property rule, was the sale leaseback transactions that permitted taxable businesses to obtain unintended benefits and enabled exempt organizations to acquire property without investing or risking any of their own funds. Congress never expressed any concern about debt-financing per se and never articulated any reason for taxing all debt-financed income. Rather, its stated rationales for enactment of the debt-financed property rules were:

¹⁶⁵ Id.

¹⁶⁶ Id.

¹⁶⁷ T.D. 8539 (May 11, 1994).

¹⁶⁸ Pub. L. No. 103-66, section 13144(a).

¹⁶⁹ Section 514(c)(9)(G)(i).

¹⁷⁰ Section 514(c)(9)(G)(ii).

¹⁷¹ Section 514(c)(9)(H).

(1) An exempt organization entering into a sale and leaseback was trading on its exemption because its only contribution to the transaction was its tax exemption;

(2) Exempt organizations could come to own the great bulk of commercial real estate in the country because they could acquire property without investing any of their own funds, thus eroding the tax base; and

(3) An exempt organization may have "sold" part of its exemption in a sale and leaseback transaction, either by paying a higher price for the property or charging lower rents than a taxable business.

None of these stated rationales, either singly or collectively, suggests an overall policy for taxing all debt-financed income.

1. Concern About Exempt Organizations Trading on Their Exemptions

Congress's concern that exempt organizations entering into sale leaseback transactions were trading on their exemptions because they were contributing nothing to the transactions other than their exemptions is only legitimate where factors in addition to the use of debt are present. These factors include "rents" that are stated as a percentage of profits, borrowing that is nonrecourse, financing provided by the seller of the property, financing of 100 percent of the purchase price, and repayment of the loan solely out of the profits of the acquired property. Congress, however, focused only on the existence of debt when it enacted the debt-financed property rules in 1969. It taxed not only the transaction where the exempt organization contributed only its tax exemption, but also the transaction where the exempt organization invested some of its own funds in the form of a down payment, and where the exempt organization risked some of its own funds because the financing for the balance of the investment was repayable according to a stated schedule or the financing was provided by a commercial institution at market rates. In such situations, where an exempt organization has any of its own funds at risk, it has made an investment decision that jeopardizes those funds and has thereby contributed more than its tax exemption to the transaction.¹⁷² If the value of the property falls below the principal amount of the funds borrowed to acquire the property, the exempt organization may lose the property as well as its investment in it.

2. Concern About Erosion of the Tax Base

A second concern of Congress was that, if exempt organizations could acquire property without investing or risking any of their own funds, they would come to own the great bulk of commercial property and erode the tax base. Congress stated its concern narrowly, referencing the situation where exempt organizations were acquiring property without investing or risking any of their own funds. This concern is clearly valid in that

¹⁷² Weigel, *supra* note 2, at 641.

narrow situation where the exempt organization is acquiring property with 100-percent nonrecourse financing payable out of the profits earned by the property acquired. In that situation, exempt organizations would not be limited at all by the extent of their resources, but that situation is far narrower than the statute that Congress enacted in 1969.

Concern over base erosion also has some validity with respect to debt-financing in general. As discussed below, debt-financing does not give exempt organizations any competitive advantage over taxable investors that is not inherent in the underlying exemption. Leverage does, however, increase an investor's return on its investment and thus leverage increases the rate at which the exempt organization can grow. This faster growth, in turn, increases incrementally the erosion of the tax base, but such an incremental increase hardly creates a risk that exempt organizations will end up owning the "great bulk of commercial property" in the country.

3. Concern About Unfair Competition -- "Selling of the Exemption"

Congress's third concern was that exempt organizations were "selling" part of their exemptions, either by paying a higher price than a taxable entity would pay or accepting lower rents. As with the first two concerns, this concern may be justified if the exempt organization is acquiring the property with 100-percent nonrecourse financing payable out of the profits of the property acquired. In such a case, because the exempt organization is not risking its own funds, it may conclude that it has nothing to lose and be willing to go along with any price and rent that the seller dictates. Yet, even in this case, an exempt organization would be expected to negotiate the best deal it could. It may not have risked any of its own funds but it did hope -- in return for its time and trouble -- to acquire the property outright, not to walk away with nothing at the end of the day. There is one situation where an exempt organization might pay more than fair market value for a property. If there were a shortage of sellers willing to enter into sale leaseback transactions, resulting in exempt organizations bidding against each other to acquire property, an exempt organization might pay in excess of fair market value.¹⁷³

In the case where the exempt organization has invested some of its own funds, the borrowing is recourse, or the payment schedule is fixed -- the typical financing arrangement -- there seems to be no reason to believe that exempt organizations will pay in excess of fair market value. They won't pay more than fair market value because borrowing gives an exempt organization no advantage over a taxable organization. For both a tax-exempt and a taxable investor, the advantage from borrowing arises from the spread between the income earned and the interest paid. The tax-exempt investor is not

¹⁷³ It is noteworthy that commentators writing before the 1950 business lease rules were enacted and the 1969 debt-financed property rules were enacted questioned whether there was any basis for the assumption that exempt organizations were paying in excess of fair market value. See Cary, *Corporate Financing Through the Sale and Leaseback of Property: Business, Tax and Policy Considerations*, 62 Harv. L. Rev. 1,23 (1948); Hall, *The Clay Brown Case and Related Problems*, 18th Ann. U. So. Cal. Law Center Tax Inst. 337 (1966).

taxed on the income but it also does not get a deduction for the interest paid. Thus, if the investor acquires property with a 10-percent rate of return with funds borrowed at 8 percent, its return on its investment is the 2-percent return that remains after it has paid the interest due on the debt. It is true that the taxable investor's net return of 2 percent will be subject to tax whereas the tax-exempt investor's return will not, but that advantage is inherent in the passive income exclusion, not in the debt-financing.

A tax-exempt investor would have an advantage if it could obtain a more favorable rate of interest than a taxable investor. Outside of the markets for tax-exempt bonds, where tax exemption is bestowed on the interest earned by the lender, there is no reason to believe that exempt organizations are able to borrow at lower rates than taxable investors. In the case of tax-exempt financing, the bonds must be used for the issuing organization's exempt purposes and cannot be used for unrelated investments. Of course, since money is fungible and the debt-financed property rules take a tracing approach to debt financing, an exempt organization with an endowment can continue to earn market rates of return on its investments while borrowing at below-market rates through tax-exempt bonds for its exempt purposes. This is admittedly an advantage for the tax-exempt investor but, again, there is no reason to assume that the ability to borrow at tax-exempt rates will lead tax-exempt investors to settle for anything less than the best return they can get. In short, there is no reason to believe, or any evidence of which this author is aware, that exempt organizations will pay more than market prices, outside of the sale-leaseback transaction where the tax-exempt entity acquires property with 100 percent nonrecourse financing provided by the seller and repayable solely out of the profits earned by the acquired property.

Furthermore, because borrowing increases both the upside and downside potential of an investment, a leveraged investment is riskier than a cash investment, a fact that may make a prudent investor more conservative as to price in a leveraged transaction. Thus, in the absence of the abusive factors present in the pre-1969 sale-leasebacks, borrowing may lead exempt organizations to seek to pay less, not more, for a given investment property.

In summary, the legislative history indicates that Congress was concerned with sale-leaseback transactions that permitted the parties to obtain unintended benefits. The taxation of all debt-financed property was an over broad response to an effort to foreclose this narrow set of transactions. Indeed, Congress itself has recognized this to be the case with the enactment of the real estate exception in section 514(c)(9). The provisions of that section were tailored by Treasury and Congress to prevent a recurrence of the sale and leaseback transactions that had prompted the passage of the debt-financed property rules in 1969. When Congress extended the exception to section 501(c)(25) organizations in 1986, Treasury acknowledged that section 514(c)(9) had achieved its purpose. At that time, Treasury did not object to the extension and testified that the changes made in 1984 had reduced the potential for creating unintended benefits.¹⁷⁴

¹⁷⁴ At that time, the Fractions Rule had not been enacted. Thus, Treasury was referring to the provisions of sections 514(c)(9)(B)(i)-(v) for all real estate investments and the requirements of

B. The Rigidity of the Debt-Financed Property Rules Encourages Formalistic Distinctions That Result in Different Treatment for Similar Transactions

Loosely stated, the debt-financed property rules are applicable only if there is indebtedness and the indebtedness would not have been incurred "but for" the acquisition or improvement of income-producing property. Because neither the statute nor the regulations define indebtedness, common law definitions apply, but these definitions have been developed in situations that may not have the same considerations as the debt-financed property rules. Further, lack of a clear overall policy for the rules makes it difficult to know how to make choices among common law definitions. For example, section 163, allowing deductions for interest, would normally be narrowly construed because it provides for a deduction, whereas principles distinguishing debt from equity would take into account factors like adequate capitalization that seemingly have no relevance for the debt-financed property rules. In short, there is no guidance as to whether the term "indebtedness" should be construed narrowly or broadly.

The Service and the courts have struggled mightily to interpret this statute and the Service has at times stretched to reach results favorable to taxpayers. With the benefit of 30 years of hindsight, the results are troubling, as the less sophisticated taxpayers have been subject to the debt-financed property rules while the more sophisticated have not. Buying stock on margin, borrowing against one CD to acquire another CD paying a higher rate, and withdrawing the cash value of life insurance policies to invest in more profitable assets all seem to fall well within the meaning of indebtedness, and have been held to be subject to the debt-financed property rules. Other transactions that do not involve debt in the traditional sense have been held not subject to the debt-financed property rules. Yet, these transactions do involve leverage in a broad sense. In a securities lending transaction, the investor uses its stock as an asset to obtain additional funds. In a short sale, the investor sells stock it does not own at the time of the sale but has borrowed and will pay back. The investor is required to post collateral to ensure the stock's performance.¹⁷⁵ Similarly, in a short futures contract, the investor sells at today's price a commodity that it does not own and must acquire either the commodity, or more typically an offsetting futures position, prior to the delivery date. In a long futures contract, the investor has bought an asset at today's price but does not need to make payment until a later date. The holders of all futures contracts, long and short, are required to post margin to ensure payment. Finally, in the case of arbitrage transactions or hedged positions, the investor is able to benefit from small price discrepancies in positions far larger than the funds the

section 514(c)(9)(B)(vi)(I) (requiring all partners to be qualified organizations) and (II) (the "Qualified Allocation Rule").

¹⁷⁵ One commentator has noted that while the theoretical basis for the Service's holding that short sales of stock may be questionable, it makes sense because it is possible for an investor to create a "synthetic short sale" of publicly traded stock by selling a call on the stock and purchasing a put. See Gallagher, *supra* note 64, at 939. Options transactions are not subject to UBIT. Section 512(b)(5).

investor has put forth. Each of these transactions, with the exception of securities lending transactions, is a leveraged investment, i.e., an investment that exceeds the investor's cash outlay and puts the investor at risk for the full value of the position. And securities lending transactions achieve the same result as leverage-- the investor uses its stock in a transaction that increases the return on its investment.

I do not mean to suggest that the Service and the courts have been wrong in their interpretation of the statute. Indeed, given the language of the statute and the lack of clear guidance as to the purpose of the statute, these results are arguably correct. But the similarities, from the standpoint of investment strategy and investment results, between the transactions that have involved debt in the traditional sense and those that involve leverage but no debt in the traditional sense, suggest that the tax treatment should be the same. The results that have been obtained under current law leave one wondering what is the objective of these rules with respect to securities and financial products.

Other aspects of the rules are also formalistic, resulting in "traps for the unwary" and opportunities for the well-advised. The "but for" test for determining whether a particular property is debt-financed is inherently formalistic, creating a tracing rule that ignores the fungible nature of money. In a case where an exempt organization has limited funds and must clearly choose between investing those funds and borrowing for exempt purposes or using those funds for exempt purposes, the indebtedness might satisfy the "but for" test. Where an exempt organization has sufficient funds to invest and also to finance its exempt activities, however, it is not likely that it will satisfy the "but for" test if it borrows funds to finance its exempt purpose.¹⁷⁶ Thus, colleges and universities with huge endowments routinely issue tax-exempt bonds. Similarly, an exempt organization can avoid tax on the gain on disposition of property if it is able to repay the loan more than 12 months before the disposition.

C. The Real Estate Exception Makes Untenable Distinctions Between Classes of Exempt Organizations

The real estate exception of section 514(c)(9) is currently available only for pension trusts, schools and their supporting organizations, and for investments made by those organizations through section 501(c)(25) title holding companies. This exception was enacted in response to lobbying, first by pension trusts in 1980, and then by schools in 1984, and represents, in the words of Treasury, a "piecemeal repeal" of the statute. Arguably, the exception could be limited to pension trusts on the grounds that their primary purpose is to invest funds in a manner that maximizes the return, consistent with fiduciary standards applicable to pension trusts. But the argument lacks force. If one accepts the premise that the primary purpose of pensions is to maximize investment return, then the debt-financed property rules should be applied only so far as necessary to prevent abusive transactions. Yet, Congress has permitted court decisions taxing stocks acquired on margin to stand for 20 years. The argument that taxation of pension funds is

¹⁷⁶ Mancino and Hill, *supra* note 43, para. 22.03[2][a].

merely deferred is equally weak, as the time value of the long period of tax exemption makes the ultimate tax a fraction of the tax that would be payable currently

Whatever force these arguments may have had with respect to pension funds was eviscerated when Congress extended the exception to schools. There simply is no principled basis for distinguishing between schools and other organizations exempt under section 501(c)(3), and Congress has not suggested that there is. There is, however, an argument for distinguishing between section 501(c)(3) organizations, which serve public charitable purposes, and other exempt organizations, which are formed for the mutual benefit of their members.

D. The Disproportionate Allocation Rule Is Overly Complex and Burdensome

The Disproportionate Allocation Rule, and particularly the Fractions Rule, has been widely criticized by lawyers who deal with its complexities and burdens in structuring real estate partnerships that include qualified organizations as partners.¹⁷⁷ A detailed technical description and analysis of these highly complex rules is beyond the scope of this paper, but any discussion of the debt-financed property rules would be incomplete without recognition of the problems caused by the rule. This section summarizes some of the most frequently mentioned problems.

The Fractions Rule is deceptively simple to state – it requires that no exempt organization have a share of overall partnership income that is smaller than its share of overall partnership loss. Its purpose is equally easy to understand -- it is intended to prevent the transfer of tax benefits from tax-exempt to taxable partners by allocating disproportionate shares of gain to the exempt partners and disproportionate shares of loss to taxable partners. Yet, despite its apparent simplicity, compliance with the rule has proven to be extremely difficult in practice.

1. Hypothetical Application of Rule to Future Years

One reason it is difficult to comply with the Fractions Rule is that it must be satisfied on an actual basis for each year of the partnership and on a hypothetical basis for each year going forward.¹⁷⁸ As a practical matter, it makes it exceedingly difficult to admit new investors or to deal with uncontrollable events such as failure of a partner to make a required capital contribution. For example, if new investors are admitted, the partnership agreement cannot simply adjust all shares going forward. If the adjustment results in an

¹⁷⁷ See, e.g., Feder and Scharfstein, *Leveraged Investments in Real Property Through Partnerships by Tax Exempt Organizations after the Revenue Act of 1987 -- A Lesson in How the Legislative Process Should Not Work*, 50 TAX LAWYER 55 (1988); Tax Section of the N.Y. State Bar Assoc., *Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations* (Feb.14, 1997); Weigel, *supra* note 2; Holloway, *supra* note 81.

¹⁷⁸ Treas. reg. section 1.514(c)-2(b)(2).

exempt organization's share of gain after the admission of new investors being less than its share of loss prior to such admission, it will fail the Fractions Rule. One solution is for the new investor to acquire a share of all partnership investments, a procedure that requires appraisal of all partnership assets. The expense and frequency with which this could be required makes it an impractical solution.¹⁷⁹

2. Standard Terms and Allocations Violate the Rule

Even though Treasury regulations exclude many common allocations from the definition of overall partnership gain and loss, many standard terms and allocations used in real estate partnerships still result in violation of the Disproportionate Allocation Rule. A recent article listed the following: (a) target allocations, i.e., provisions that provide that allocations should be made in such a manner that, if the partnership were to sell all its assets and liquidate on the last day of the tax year, the capital accounts of the partners would equal the distributions that the partners are entitled to receive under the partnership agreement; (b) carried interest distributions that are made on a property-by-property basis; (c) management fee payments; (d) changes in relative shares of partners as a result of events occurring over the life of the partnership; (e) clawbacks (i.e., repayment to partnership of excess carried interest distributions) in excess of deficit capital accounts; and (g) curative allocations to reduce the impact of special allocations made to comply with the section 704(b) requirements.¹⁸⁰

3. Catastrophic Penalties

The penalty for failing the Disproportionate Allocation Rule is that all qualified organization partners lose the benefit of the real estate exemption and are subject to UBIT under the debt-financed property rules for all years of the partnership's existence or, in some cases, for the year of noncompliance and all subsequent years.¹⁸¹ This penalty may be all out of proportion to the partnership's level of noncompliance and is extremely harsh in light of the difficulty of complying with the Fractions Rule and the Substantial Economic Effect Test over the life of a partnership. It is in contrast to the operation of similar provisions. For example, if the Qualified Allocation Rule of Section 168(h)(6) is not met, the penalty is that the partnership is required to compute depreciation on part of its property as "tax-exempt use" property.¹⁸² Similarly, if the substantial economic effect rules of section 704 are not met, the partnership allocations are revised to reflect the economics of the partner's interests.¹⁸³ The draconian effect of the penalty for failure to comply with the Fractions Rule is further exacerbated by the fact that the penalty is applied on a partnership basis, not on a partner basis. Thus, if one qualified organization's allocation fails the test, all partners are penalized.

¹⁷⁹ Weigel, *supra* note 2, at 633.

¹⁸⁰ Holloway, *supra* note 81.

¹⁸¹ Holloway, *supra* note 81, citing Treas. reg. sections 1.514(c)-2(b)(2) and 1.514(c)-2(k)(1).

¹⁸² Weigel, *supra* note 2, at 634.

¹⁸³ Weigel, *supra* note 2, at 635.

4. Inconsistencies Between the Fractions Rule and the Substantial Economic Effect Test

The legislative history of section 514(c)(9)(E) acknowledged that inconsistencies might exist between the Fractions Rule and the Substantial Economic Effect Test and directed that Treasury issue regulations to resolve the conflicts.¹⁸⁴ Congress further indicated that conflicts should be resolved giving precedence to the Fractions Rule.¹⁸⁵ To date, however, Treasury has not issued regulations addressing the conflicts.

E. The Computation Rules Overtax Exempt Organizations

Section 514 is intended to tax that portion of income that is debt-financed but in practice it taxes a greater amount.¹⁸⁶ This is best illustrated by comparing two cases. In the first situation, an exempt organization uses its own funds to purchase \$100,000 worth of stock that pays a dividend of \$7,000. The dividend is excluded from UBTI. In the second situation, an exempt organization purchases \$200,000 of the same stock, using \$100,000 of its own funds and borrowing \$100,000 at 6-percent interest. The exempt organization earns a dividend of \$14,000 and, after paying \$6,000 in interest on its debt, an increase of \$1,000 over its return on the unleveraged investment. In theory, the exempt organization should be taxed on the \$1,000 of incremental income. In practice, it is taxed on \$4,000. The computation rules tax a fraction of income (less deductions) equal to the average acquisition indebtedness (\$100,000) over the basis (\$200,000). Thus, the exempt organization in the second situation is taxed on 50 percent of \$8,000 (\$14,000 in dividends received less \$6,000 of interest paid).

F. The Choice of Investment Vehicle Has an Unprincipled Impact on Application of the Debt-Financed Property Rules.

As the discussion above indicates, exempt organizations can avoid application of the debt-financed property rules through some investment vehicles, such as foreign corporations and REITs. On the other hand, a qualified organization may lose the benefit of the real estate exception if it acquires property through a section 501(c)(2) real estate title holding company or if a section 501(c)(25) title holding company in which it has an interest acquires an interest in a real estate partnership. Differences of this type in application of the rules create a "trap for the unwary" and complicate nontax business decisions without advancing any apparent tax policy.

VII. Proposals for Change

A. Should the Debt-Financed Property Rules Be Repealed?

¹⁸⁴ S. Rep. No. 445, 100th Cong., 2d Sess. 428 (1988).

¹⁸⁵ *Id.*

¹⁸⁶ Weigel, *supra* note 2, at 627-29.

At least one commentator has suggested that the debt-financed property rules should be repealed,¹⁸⁷ another commentator has broadly hinted that they should be repealed,¹⁸⁸ and the Tax Section of the American Bar Association has suggested that the Fractions Rule be repealed.¹⁸⁹ Repeal requires consideration of two issues. First, if section 514 were repealed, would abusive transactions proliferate as they did before enactment of the rules? Second, is there something inherently bad about debt that should be discouraged by taxing debt-financed investments?

1. Are the Rules Necessary to Prevent Abusive Transactions?

a. Real Estate -- Direct Investments

In the context of direct investments in real estate, as opposed to investments by a partnership, a persuasive case has been made in a detailed analysis by a recent commentator that current provisions of the code leave only a narrow class of sale leaseback transactions with the potential for the type of abuse that existed prior to 1969 and that the reduction in tax that the seller achieves is modest.¹⁹⁰ He points to the following provisions:

(1) Section 512(b)(3), enacted in 1969, the same year as the debt-financed property rules, excludes rent from the passive income exclusions if the amount payable depends in whole or in part on the income or profits derived from the leased property.

(2) Section 483, added in 1964, and section 1274 require the seller to recognize interest income on the deferred installments of the purchase price, so that the entire amount cannot be reported as capital gain, as it was in the Clay Brown type of transactions.

¹⁸⁷ Weigel, *supra* note 2, at 658.

¹⁸⁸ Brody, *supra* note 3, at 618. ("The only possible explanation for retaining the 1969 legislation is the fear of the power of a well-endowed charitable sector.")

¹⁸⁹ Thoughts on the Impact of Tax Complexity on Small Businesses: Hearings Before the Subcomm. on Tax, Finance, and Exports of the House Small Business Comm., 106th Cong., 2d Sess. 1536 (2000) (statement of Pamela F. Olson, chair of the ABA Tax Section.). Hearing Before the Committee on Finance on the Subject of Tax Simplification, 107th Cong., 1st Sess. (Apr. 26, 2001) (statement of Richard M. Lipton, ABA Tax Section chair).

¹⁹⁰ Weigel, *supra* note 2, 649-53.

(3) Section 1250 requires the seller to recognize recaptured depreciation as ordinary income immediately upon the sale.

(4) Section 453A requires the seller to pay interest on the tax attributable to deferred installments of the purchase price.

In addition, the seller loses the benefit of depreciation deductions after the sale and also loses the residual value of the property.¹⁹¹ Finally, section 467 also curtails the benefits of sale-leaseback transactions.

b. Real Estate -- Partnership Investments

In the case of real estate investments through partnerships, repeal of Section 514 raises the question whether the Substantial Economic Effect Test of Section 704(b) would be sufficient to prevent the transfer of benefits from qualified organization partners to taxable partners. To put it another way, is the Fractions Rule combined with the Substantial Economic Effect Test a case of "belt and suspenders" or does each rule serve a separate and independent purpose? By requiring that a qualified organization can never have a share of a partnership's overall income that is greater than its share of overall partnership loss, the Fractions Rule ensures that there cannot be a transfer of benefits from qualified organizations to taxable partners. The same cannot be said of the Substantial Economic Effect Test and, thus, the repeal of section 514 would open the door to the transfer of benefits. The question then becomes whether the Substantial Economic Effect Test is sufficiently robust to prevent most transfers of benefits and whether some minimal level of tax avoidance can or should be tolerated.¹⁹² If the Fractions Rule were as easy to apply as it is to state, then it would be clear that it should be retained but, given the extraordinary complexities and burdens that the Fractions Rule imposes on partnerships with qualified organization partners, the question is more difficult.

Ultimately, it is a question of balancing the interests of the government in preserving the tax base and preventing the transfer of benefits from qualified organizations to taxable persons against the equally important interests of the government in facilitating the investment of capital without undue burdens, expenses, and restrictions. Practitioners in this area have complained since the enactment of the Fractions Rule that it is unworkable, creates extraordinary and costly burdens for even the simplest transactions, and that one can never be certain that a partnership has complied with the rule. Critics have also pointed out that the exempt sector is a significant source of capital for real estate investments. In balancing these competing interests, there is no reason to permit transfer of benefits if a rule can be developed that will prevent such transfers with vastly reduced complexities and burdens. If such a rule cannot be developed, then repeal of section 514

¹⁹¹ Gallagher, *supra* note 64, at 936.

¹⁹² A question to be considered is why special rules are necessary for organizations that are exempt under section 501(a) but not others that are exempt such as foreign persons, governments, and corporations. See McDowell *supra* note 95, at 743 (comments of Harvey Dale).

and reliance on the Substantial Economic Effect Test is justifiable. Section 704(b) could be buttressed with a tax avoidance rule, as suggested by the Tax Section of the New York State Bar Association, and broad regulatory authority to prevent abusive transactions.¹⁹³

c. Personal Property

There have not been any abusive transactions involving debt-financed personal property. Because rents from personal property have never been excluded from UBTI, there could not be transactions of the Clay Brown variety involving only personal property. Conceivably, there could be abusive transactions involving contingent interest payments but such payments could be subjected to tax under the section 512 regulations which provide that whether any item of income is excluded from UBTI depends upon the facts and circumstances.¹⁹⁴ Arguably, there could be abusive transactions involving partnerships that would escape the Substantial Economic Effect Test of Section 704. In short, it is hard to say that there could never be an abuse. As with real estate partnerships, the question is whether the cost of the debt-financed property rules in terms of complexity, uncertainty, rigidity, and inequity can be justified on the grounds that there might be a potential abuse. In the case of personal property, where there is not even a history of abusive transactions, it is hard to justify these rules.

2. Should the Rules Be Retained to Discourage Debt Financing?

The purpose of debt is to increase the investor's return on investment. The trade-off for the increased return is taking on greater risk. For example, if an investor buys \$100,000 worth of stock and the value of the stock increases by 10 percent in one year, the investor has earned \$10,000. If this same investor borrowed another \$100,000 at 8-percent interest and invested \$200,000 in the same stock, it would earn \$20,000 on the stock and, after paying \$8,000 in interest on its debt, would net \$12,000, an increase in its rate of return from 10 percent to 12 percent. Of course, if the \$200,000 in stock did not earn at least \$8,000 to cover the interest payment, the investor would have a loss. Thus, the leveraged investment is riskier because the return on the investment must be at least 4 percent for the investor to avoid a loss. This higher risk, however, can be reduced through diversification and hedging.¹⁹⁵

Simply because a leveraged investment is riskier than the same investment on cash terms does not justify the debt-financed property rules. The amount of risk that an exempt organization undertakes is a matter of fiduciary law and, in the case of private foundations and pension funds, also a matter of jeopardy investment rules and ERISA,

¹⁹³ See Tax Section of the N.Y. State Bar Assoc., *supra* note 177.

¹⁹⁴ Treas. reg. section 1.512-1; but cf. section 856(f) (defining interest for purposes of the gross income test applicable to REITs).

¹⁹⁵ See, e.g., Lenzner & Johnson, "Harvard is Knee Deep in Derivatives," *Forbes*, Nov. 20, 1995 (cover story).

respectively. Interestingly, the Restatement (Third) of Trusts (The Prudent Investor Rule) provides that borrowing is permissible if the tactic is "employed selectively and cautiously."¹⁹⁶ As two commentators noted:

In most cases where borrowing has been at issue, the trustee was using trust funds to carry on a business. But the trustee who levers a market fund, like a trustee who buys levered common stock, remain a passive investor. . . Obviously, leverage increases the risk of the trust assets. . . . But the proper question is whether the risk is excessive, not whether it is achieved by leverage.¹⁹⁷

In summary, debt financing increases risk but that is not a reason to discourage all debt financing without regard to the level of risk, as the debt-financed property rules do. Moreover, the debt-financed property rules are unnecessary for this purpose because other areas of the law set fiduciary standards.

3. Summary

Whether section 514 should be repealed depends upon whether the debt-financed property is personal property or real property and, in the case of real property, whether the exempt organization makes the investment directly or indirectly through a partnership.

a. Personal Property

Section 514 should be repealed with respect to personal property; it serves no discernable public policy and in practice has imposed constraints on nonabusive investment transactions and resulted in inequitable treatment of similar transactions.

b. Real Estate -- Direct Investments

Section 514 could be repealed with respect to direct real estate investments and leave little opportunity for tax avoidance, as other sections of the code now prevent the types of abuses that section 514 was intended to foreclose. On the other hand, after numerous amendments, section 514(c)(9) now seems to work well with respect to direct real estate investments, and it could be argued that section 514 should be retained and the real estate exception should be extended to all section 501(c)(3) organizations. It would then be necessary to attempt to rationalize the impact of different investment vehicles on the results obtained under section 514.

¹⁹⁶ Restatement (Third) of Trusts (The Prudent Investor Rule), section 227 cmt h at 29 (1992), cited in Brody, *supra* note 3, at 616, n. 158.

¹⁹⁷ Langben & Posner, *Market Funds and Trust-Investment Law*, 1 AM. B. FOUND. J. 1, 33 (1976), cited in Brody, *supra* note 3, at 616, n. 158.

c. Real Estate -- Partnership Investments

The most difficult questions arise in the context of real estate partnership investments. Arguments of practitioners strongly suggest that the current rules impose an undue burden and constraint on real estate investments, a situation that impacts not only exempt organizations, but also the real estate markets and the economy. At a minimum, major revisions to the Disproportionate Allocation Rule are required. If the rules cannot be revised to eliminate the current complexities and burdens, then a strong case can be made for striking a balance between competing public interests in favor of repealing Section 514 and relying on the Substantial Economic Effect Test, perhaps backstopped with broad regulatory authority.

B. If the Debt-Financed Property Rules Are Not Repealed, What Changes Should Be Made?

There are compelling reasons for repealing section 514, particularly as it applies to personal property and direct investments in real estate, and it is hoped that Congress will give serious consideration to repeal. If the debt-financed property rules are not repealed, they should be substantially revised. Any consideration of revision should include the following:

1. Exclude regular and routine investments in intangible personal property from UBTI and the debt-financed property rules.
2. Extend section 514(c)(9) real estate exception to all section 501(c)(3) organizations.
3. So far as possible, eliminate unequal treatment under section 514 as a result of choice of investment vehicles, where no policy is served by the different treatment. Extend the Real Estate Exception to section 501(c)(2) title holding companies if owned by a Qualified Organization and allow section 501(c)(25) title holding companies to hold interests in partnerships.
4. Revise the Fractions Rule to make it workable and reasonably consistent with standard nonabusive practices in the real estate industry and adopt penalties that are more in line with the degree of noncompliance. If the Fractions Rule cannot be rehabilitated, repeal it and rely on the Substantial Economic Effect Test.
5. Revise the computation rules so that exempt organizations are taxed only on the incremental increase in return achieved through debt financing.

VIII. Summary and Conclusion

Although the debt-financed property rules were enacted to deal with abusive sale-leaseback transactions, they apply to all debt-financed property (other than debt-financed

real estate owned by pensions and schools) and effectively discourage all leveraged investments by exempt organizations (other than real estate investments by pensions and schools). There is no strong policy reason for taxing all leveraged income of exempt organizations. Repeal of the debt-financed property rules would further tax policy objectives of horizontal equity and simplicity and would likely have little impact on tax collection efforts. Further, repeal of the rules would remove a significant constraint and burden from the capital markets. If the rules are not repealed, they should be substantially revised.