

R. TAXATION OF PASSIVE INCOME AS UNRELATED BUSINESS INCOME -- IRC 512(b)(13) and IRC 514

The provisions of IRC 512(b)(13) and IRC 514 have application to all categories of organizations exempt from income tax under IRC 501(a), to trusts described in IRC 664, and to trusts taking deductions under IRC 642(c). Generally, these sections apply to all organizations exempt under IRC 501(a) in the same manner. However, IRC 512(a)(3) gives special rules for organizations exempt under IRC 501(c)(7) or IRC 501(c)(9). IRC 681 makes the unrelated business income tax provisions applicable to trusts taking deductions under IRC 642(c). Deductions otherwise qualifying under IRC 642(c) are disallowed if they are allocable to income that IRC 511-514 classifies as unrelated business taxable income.

One approach to unrelated business income issues is to begin the analysis by splitting all items of income of an organization into two broad categories. One category consists of income from the sale of goods or performance of services; the other category consists of passive income. The first category consists of income, the taxability of which is essentially determined by the provisions of IRC 513. This discussion is aimed at the second category.

The second category consists of income that is normally not taxable because of the specific exclusions of IRC 512(b)(1), 512(b)(2), 512(b)(3) or 512(b)(5). However, there are two Code provisions, IRC 514 and 512(b)(13) (discussed below), that override these exclusions and are the subject of this discussion. Interest, dividends, annuities, rents from real property and royalties are excluded by IRC 512(b)(1), 512(b)(2) or 512(b)(3). IRC 512(b)(5) excludes gain (or loss) on the sale of property but only if the gain (or loss) is not from sale of inventory or otherwise from property held for sale to customers in the ordinary course of business. IRC 512(b)(1) also contains an exclusion for income from security lending, a type of income that is infrequently encountered. See IRC 512(a)(5) for a definition of it.

Although not as significant as IRC 514, IRC 512(b)(13) should be considered prior to IRC 514. This is because income taxed under IRC 512(b)(13) is not taxed by reason of IRC 514. The provisions of IRC 512(b)(13) only apply to income derived from a controlled organization. It only applies to interest, rents, annuities and royalties. The fact that dividends are excluded demonstrates the purpose of IRC 512(b)(13). It is designed to prevent an exempt organization from

greatly reducing or eliminating unrelated business taxable income through the use of a controlled subsidiary, e.g., eliminating taxable income by having the subsidiary deduct from its taxable income rent paid to the parent for use of real property owned by the parent. Dividends are not included because the payment of dividends cannot be deducted in computing taxable income.

It makes no difference if the controlled organization is exempt or nonexempt. IRC 512(b)(13) still applies. If an organization is a stock corporation, control of it is determined by ownership of the stock. A corporation is controlled by an exempt organization if the exempt organization owns at least 80 percent of the voting stock of the corporation and at least 80 percent of the total shares of all other stock. Reg. 1.512(b)-1(1)(4) provides that control of a nonstock organization is determined by reference to direct or indirect control of trustees or directors. If an exempt organization directly or indirectly controls 80 percent of the trustees or directors of an organization, control within the meaning of IRC 512(b)(13) exists.

If a controlled organization is present, any interest, rents, annuities and royalties paid to the controlling exempt organization is taxed as income from an unrelated business basically according to the percentage of the income of the controlled organization that is unrelated business taxable income or would be unrelated business taxable income if the controlled organization were exempt. This is accomplished by multiplying a fraction times the pertinent income item. If the controlled organization is exempt from taxation, the numerator of the fraction is unrelated business taxable income. Reg. 1.512(b)-1(k)(2)(i). The denominator consists of the greater of the unrelated business taxable income of the exempt organization or what its taxable income would be if it were not exempt, both determined without regard to any amounts paid directly or indirectly to the controlling exempt organization. Reg. 1.512(b)-1(k)(2)(i). Nonexempt controlled organizations are treated similarly. However, different terminology is used. "Excess taxable income" is used in the numerator of the fraction. Reg. 1.512(b)-1(k)(3)(i). "Excess taxable income" is that portion of the controlled organization's taxable income that would constitute unrelated business taxable income, all determined as if the income of the controlled organization were directly derived by the controlling organization. Reg. 1.512(b)-1(k)(3)(i). The denominator consists of the greater of taxable income of the controlled organization or excess taxable income. Again, both amounts are determined without regard to amounts paid to the controlling organization.

When controlled organizations are present, an additional point needs to be considered. That portion of any interest, rents, annuities or royalties not taxed by IRC 512(b)(13) may be subject to IRC 514.

IRC 514 taxes income described in paragraphs (1), (2), (3) and (5) of IRC 512(b) but only to the extent that the property from which the income is derived is debt-financed (acquired through indebtedness). The percentage of income taxed is proportionate to the debt on the property. These provisions were structured in 1969 to eliminate successful use of complex schemes to convert ordinary income of businesses into capital gain by the use of a sale and leaseback arrangement involving an exempt organization. See *Clay B. Brown v. Commissioner*, 380 U.S. 563 (1965) for an example of successful use of this device prior to 1969.

Before discussing IRC 514, again note that IRC 514(b)(1)(B) makes IRC 514 inapplicable to income taxed by any other provision of IRC 511-514. Under IRC 514, it is necessary to consider whether the property from which the income is derived is held for a purpose substantially related to the exempt purposes of the organization, aside from the need for income. If the income is derived from property substantially all of the use of which is for related purposes, the income from the property is not subject to tax. Reg. 1.514(b)-1(b)(1)(ii) defines "substantially all" as 85 percent. However, it is beyond the scope of this discussion to discuss what is or is not related. The result depends on the IRC classification of the organization and the nature of a particular organization's exempt or charitable purposes. For purposes of this discussion, it is assumed that the property from which the income is derived is not held for any substantially related purpose. IRC 514(b)(2) provides a special rule for determining exempt uses where related organizations are present.

Passive income from property that is research income described in IRC 512(b)(7), 512(b)(8), or 512(b)(9) is not subject to IRC 514. IRC 514(b)(1)(C). Passive income from property is excluded by IRC 514(b)(1)(D) to the extent that it is used in any trade or business described in paragraph (1), (2), or (3) of IRC 513(a), relating in part to businesses conducted with volunteer labor or which consist of the sale of donated goods.

There is a special exception to debt-financed property for property that is to be converted to an exempt use. It applies to real property which is to be converted within ten years, 15 years for churches, to an exempt use. One important requirement eliminates most property from using this rule. IRC 514(b)(3)(C)(i)

eliminates use of the rule for any structure that is not required to be removed or demolished as part of the conversion.

An organization planning to convert property to an exempt use may not be able to use IRC 514(b)(3) to claim nontax treatment prior to the time of the conversion; it may have to pay tax prior to the conversion and then file a claim for a refund after the conversion. Whether or not advance nontax treatment can be obtained depends on whether the organization is a church and whether the property to be converted is in the neighborhood of other property which the organization already uses in carrying out its exempt or charitable purposes. Organizations other than churches must rely on the property being in the "neighborhood" if they are to receive advance nontax treatment.

"Neighborhood" is defined in Reg. 1.514(b)-1(d)(1)(ii). There, neighborhood is limited generally to property that is contiguous to property that is already used in furtherance of an exempt purpose or which would be contiguous but for the existence of a road, street, railroad, stream or similar property. If this standard is not met, the property must be located within 1 mile of other property used in carrying out an exempt purpose, and it must also be established that facts and circumstances make it impractical to acquire contiguous property.

If the property meets the requirements of IRC 514(b)(3), it automatically is entitled to the benefits (advance nontax treatment) for five years. Five years after acquiring the property, an organization must request a ruling to continue the benefits of the neighborhood land rule for another five years. Reg. 1.514(b)-1(d)(1)(iii). Actually, the ruling must be requested at least 90 days prior to the end of the fifth year. In order to receive a favorable ruling, the organization must submit information to the satisfaction of the Commissioner that the conversion will be completed within the allowed time period.

IRC 514(b)(3)(E) sets forth a special rule for churches. Churches do not have to meet the neighborhood requirement in order to receive advance nontax treatment. However, churches are required to apply for a ruling to continue to receive the benefit after five years, but a favorable ruling covers the next ten years.

An organization cannot use IRC 514(b)(3) to escape taxation if the income from the property would have been subject to taxation under IRC 514 as it existed prior to amendment in 1969, i.e., there must not be a lease of the property for a term of five years or more (business lease). IRC 514(b)(3)(C)(iii). The business lease provisions are no longer contained in IRC 514. They can now be found in

Reg. 1.514(f)-1 and 1.514(g)-1. The business lease provisions were deleted from the Code because they apply to so few situations.

This has been a general discussion of the special rule for property to be converted to an exempt use. The rule is quite complicated, and it may be necessary to refer to the regulations on additional points that may need to be taken into account in handling a particular case.

Taxation of income under IRC 514 requires a finding that the property producing the income be debt-financed. Normally, there has been no problem as to what debt is. Basically, debt is an obligation to pay a specific sum in the future. Usually, periodic interest payments are required as long as the debt exists; otherwise, debt would be expected to be found only when there is a lien against particular property. IRC 514(c)(2)(C) contains a special rule for tax liens and liens for assessment.

Special statutory rules exist for three other items. IRC 514(c)(5) states that annuity obligations do not constitute indebtedness for purposes of IRC 514, provided that the annuity is the sole consideration issued in exchange for property and has a value that is less than 90 percent of the property received in the exchange. A further requirement is that the annuity be paid to one or two individuals who are alive at the time of the transfer and that there be no minimum or maximum amount to be paid. For purposes of IRC 514(c)(5) the annuity to be paid cannot be adjusted by reference to the income from any property, i.e., the annuity must be a set periodic payment.

Any indebtedness that is incurred that is inherent in performing exempt purposes is not indebtedness for purposes of IRC 514. See IRC 514(c)(4). Acceptance of deposits by credit unions is specifically listed as an example. This would also apply to commitments to make grants in furtherance of exempt purposes in the event they constituted debt.

IRC 514(c)(6) excludes certain federal financing. Obligations insured by the Federal Housing Administration are not considered to be indebtedness for purposes of IRC 514 if the obligation is to finance the purchase, rehabilitation or construction of housing for low and moderate income persons.

Generally, the fact that property is acquired subject to debt does not prevent the property from being considered to be debt-financed for purposes of IRC 514. IRC 514(c)(2)(A). However, important exceptions exist for property acquired by

gift. If the property subject to mortgage is acquired by will the debt will not be taken into account under IRC 514 for a period of ten years following the date of the gift. IRC 514(c)(2)(B). If the property subject to a mortgage is acquired by gift other than by will, the debt will not be taken into account under IRC 514 for a period of ten years after the gift, provided the donor held the property for more than five years prior to the gift and the mortgage was placed on the property more than five years prior to the gift. The above exceptions only apply if the mortgage is not assumed. (IRC 514(c)(2)(B) bars use of the exception if the property is acquired by part sale and part gift.)

Since the exceptions do not apply if the mortgage is assumed, a question that can arise is what is meant by "subject" as opposed to "assume". Property is owned subject to a mortgage if the liability of the owner of the property for payment of the debt is restricted to loss of the property. A mortgage is assumed if the owner of the property agrees to pay the debt irrespective of what happens to the property that is mortgaged. This becomes material if the debt is not paid and the property used to secure the debt has a value less than the amount of the debt. If the mortgage is assumed, the owner of the property is legally required to pay that portion of the debt that is not satisfied by the proceeds from the sale of the mortgaged property. Under normal circumstances, the fact that the exempt organization is making the mortgage payments is irrelevant.

Once debt is found and it is determined that there is unrelated income from property, it is necessary to match indebtedness with particular items of income from property. IRC 514(c)(1) is drafted so that property will not escape classification as unrelated debt-financed income merely because the debt was not incurred at the same time as the income producing property was acquired or improved. IRC 514(c)(1)(B) states that indebtedness incurred after the acquisition or improvement of income producing property will cause income from the property to be unrelated debt financed income if the incurrence of the debt was reasonably foreseeable at the time of such acquisition. IRC 514(c)(1)(B) produces a similar result if the debt is incurred prior to its use to acquire property.

In matching income and debt, the first factor to consider is use of the indebtedness. If the indebtedness is used to finance income producing property, it is income from that property that is subject to IRC 514. See example 1, Reg. 1.514(c)-1(a)(2). If indebtedness is not being used to finance property producing passive income, attention should shift to property producing income that is held at the time the indebtedness is incurred. If the acquisition of property occurred at a time when it was reasonably foreseeable that debt would be incurred, income from

that property would be subject to IRC 514. An illustration of this is provided by example 2, Reg. 1.514(c)-1(a)(2). There, an organization used working capital that would be needed to carry out its exempt purposes to remodel an office building that was held to produce rent. The office building became debt-financed property when the organization borrowed funds at a later time to replace the working capital.

A more detailed illustration is provided by example 3, Reg. 1.514(c)-1(a)(2). There, an exempt school sold a classroom building to an organization that it did not control. The school took back a purchase money mortgage of \$2 million to help finance the sale to the purchaser. At the time the purchase money mortgage was acquired, the school was aware that it would have to borrow funds to build a new classroom building. In the year following the acquisition of the purchase money mortgage, the school borrowed \$2.5 million to finance construction of a new classroom building. Since the construction loan was reasonably foreseeable at the time the purchase money mortgage was acquired, the income from the \$2 million purchase money mortgage became subject to IRC 514 effective with the time the \$2.5 million was borrowed. The thought is that the school should either have required the purchaser of the old classroom building to have obtained financing from other sources or, alternately, the purchase money mortgage should have been sold to help finance construction of the new classroom building. The amount of debt (acquisition indebtedness) for purposes of IRC 514 is \$2 million.

Both of the above examples involve debt that was incurred soon after acquisition of income producing property. The sooner the debt is incurred after acquisition of property, the more likely that it was reasonably foreseeable that debt would be incurred.

In the case of partnership interests, it is clear that debt incurred by the partnership could only cause income from the partnership to be taxed by IRC 514. (Note that IRC 512(c) causes income of a partnership to retain its character in the hands of a partner that is subject to IRC 511-514.)

The percentage of net income taxed by IRC 514 is determined by a ratio of the applicable debt to the basis in the property. IRC 514(a)(1). The resulting percentage figure is multiplied by the gross income and related expenses from the debt-financed property. If the disposal of property causes recognition of a loss, the applicable percentage is multiplied by the loss. The debt-basis ratio cannot exceed 100%. IRC 514(a)(1).

It is necessary to consider the nature of the income when computing the figure to be used for debt in the debt-basis ratio. For sale or other disposition of property, the amount of debt is the highest amount of debt that existed for the 12 month period preceding the disposition of the property. Reg. 1.514(a)-1(a)(1)(v). For all other types of passive income from property, the amount of debt is the average amount of debt for the year in which the income is earned. Reg. 1.514(a)-1(a)(1)(ii). The average amount is computed by totalling the amount of debt for the first day of each month and dividing by 12. Reg. 1.514(a)-1(a)(3).

An average figure is used in determining basis for purposes of the debt-basis ratio. Reg. 1.514-1(a)(2) sets forth the rule to be used for all situations under IRC 514. It states that the figure to be used for "basis" is an average of the basis of the property on the first day of the tax year that the property is held and the basis of the property on the last day of the tax year on which the property was held.

Generally, gross income and related expenses are computed for purposes of IRC 514 in the same manner as for taxable persons. However, one important difference exists. IRC 514(a)(3) prohibits the use of accelerated depreciation. The straight line method of computing depreciation is required to be used.

Once the applicable percentage is applied to the income and related expenses of the debt-financed property, the resulting figures are lumped in with any other unrelated business income. For example, income taxed by IRC 512(b)(13) or IRC 514 retains no special character for purposes of the deduction modifications of IRC 512(b)(10), 512(b)(11) or 512(b)(12).

As a final note, it is fairly easy to determine that IRC 512(b)(13) and IRC 514 have no application to many organizations. For many organizations, analysis of financial statements, returns and charts of accounts will quickly reveal that there is no income tax liability by reason of IRC 512(b)(13) or IRC 514. If an organization has no interest expenses and has no liabilities during the year other than accounts payable or contributions, gifts, grants payable, it will be evident that IRC 514 is inapplicable. However, it useful to analyze accounts payable because evidence of IRC 514 debt may be buried there.

IRC 512(b)(13) only applies to certain items of income from subsidiaries. In many situations, it will be immediately evident that the organization has no subsidiary.