

Unrelated income; debt-financed investment by employees' trust. The investment by an exempt employees' trust in a partnership that was organized to invest in securities and borrows funds for that purpose may result in unrelated business taxable income to the extent its share of partnership income is derived from or on account of the debt-financed securities.

Advice has been requested whether, under the circumstances described below, investment activity by an exempt employees' trust may result in unrelated business taxable income within the meaning of section 512 of the Internal Revenue Code of 1954.

An exempt employees' trust became a partner in a partnership that was organized to make investments in securities. All partners paid a fixed dollar amount directly to the partnership to become members. The partnership borrows funds to invest in securities and is primarily liable for repayment of the borrowed principal and interest thereon. However, if it is unable to repay any portion when due, the partners become liable for repayment of the obligation in proportion to their respective interests.

Section 511 of the Code imposes a tax on the unrelated business taxable income of certain organizations, one of which is an exempt employees' pension, profit-sharing, or stock bonus trust.

Sections 512(b)(4) and 514(a)(1) of the Code require that a portion of the income derived from or on account of each debt-financed property shall be included as an item of gross income derived from an unrelated trade or business.

Section 514(b) of the Code defines 'debt-financed property' to mean, with certain exceptions, any property which is held to produce income and with respect to which there is an 'acquisition indebtedness' at any time during the taxable year. Under section 514(b)(1)(A)(i), 'debt-financed property' does not include any property substantially all of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its purpose or function constituting the basis for its exemption. Acquisition indebtedness, in turn, is defined in section 514(c) to include the unpaid amount of indebtedness incurred in acquiring or improving the property. However, section 514(c)(4) states that acquisition indebtedness does not include indebtedness the incurrence of which is inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption.

Section 1.401-1(a)(2)(i) of the Income Tax Regulations provides that a qualified pension plan is one established and maintained by an employer to provide for the payment of

definitely determinable benefits to the employees or their beneficiaries after the retirement of such employees.

Rev. Rul. 71-311, 1971-2 C.B. 184, states that although there is no prohibition in the Code or regulations against a qualified employees' trust borrowing funds to purchase investments, it is subject to tax on unrelated business taxable income under section 511 of the Code. In this connection, the Revenue Ruling cites section 512(b)(4) and 514 requiring the inclusion of certain debt-financed income in unrelated business taxable income.

In this case the employees' trust is a partner. Section 1.702-(a) of the regulations provides that each partner is required to take into account separately in his return his distributive share of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9).

The exempt trust is part of a plan which is maintained to pay definitely determinable benefits to its participants or their beneficiaries without regard to profits. The indebtedness was used to acquire investment property, and would not have occurred but for the investment property acquisition. Therefore, whether the trust's investment activity can result in unrelated business taxable income is determined by whether its share of any partnership income is derived from or on account of debt-financed property. In making this determination it is necessary to ascertain whether the exception contained in either section 514(b)(1)(A)(i) of the Code or 514(c)(4) is applicable.

In this case an indebtedness was incurred to acquire property for investment purposes. This indebtedness was an acquisition indebtedness as defined in section 514(c) of the Code and its incurrence was not inherent in the performance or exercise of the purpose of function constituting the basis of the trust's exemption, since that purpose is to receive the contributions of the employer, the employees, or both, and to use the contributions and increments thereon to provide pension benefits to the employee participants at retirement.

Furthermore, the investment property acquired with the borrowed funds was not substantially related (aside from the need of the trust for funds) to the exercise or performance by the trust of the purpose or function constituting the basis for its exemption.

See also Senate Report No. 91-552 (1st Session), 1969-3 C.B. 423, at page 465, which states that the provisions of section 514 cannot be circumvented where investment property is also acquired and the borrowing would not have occurred but for the investment property acquisition.

Accordingly, the exempt trust's investment activity may result in unrelated business taxable income within the meaning of section 512 of the Code.