

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

June 19, 2017

Number: **201741019**

Release Date: 10/13/2017

Third Party Communication: None  
Date of Communication: Not Applicable

Index (UIL) No.: 511.01-00, 512.00-00, 513.00-00, 513.01-00, 514.00-00  
CASE-MIS No.: TAM-136986-16

Chief, Appeals Office  
Charlotte, NC

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No  
Year(s) Involved:  
Date of Conference:

LEGEND:

Trust	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Year 1	=
Year 2	=
\$A	=
\$B	=
LP 1	=
LP 2	=
LP 3	=

## ISSUE(S):

Whether certain income of the Trust is subject to unrelated business income tax for the taxable year ending Date 1.

## Specifically:

- (1) Whether the Trust is subject to unrelated business income tax.
- (2) If so, whether the Trust's \_\_\_\_\_ activities, with respect to partnerships and debt-financed property, are substantially related to the Trust's exempt purpose.

## CONCLUSION(S):

- (1) The Trust is subject to unrelated business income tax.
- (2) The Trust's \_\_\_\_\_ activities, with respect to partnerships and debt-financed property, are not substantially related to the Trust's exempt purpose.<sup>1</sup>

Thus, certain income of the Trust is subject to unrelated business income tax for the taxable year ending Date 1.

## FACTS:

The Trust is exempt from federal income tax as an organization described under section \_\_\_\_\_ of the Internal Revenue Code (the Code)

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<sup>1</sup> This technical advice memorandum addresses only the Trust's \_\_\_\_\_ activities related to partnerships and debt-financed property. Other \_\_\_\_\_ activities of the Trust are not at issue (see generally, IRC §513(c)).

The Internal Revenue Code (Title 26 of the United States Code) is referenced herein as the "IRC." Similarly, the Treasury Regulations (Title 26 of the Code of Federal Regulations) are referenced as "Treas. Reg."

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<sup>15</sup> The Trust  
instruments; the Trust has indicated that these  
and debt-financed assets.<sup>16</sup>

assets in various  
include partnership interests

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Income from Partnerships and Debt-Financed Property

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For the taxable year ending Date 1, the Trust reported \$A as unrelated business taxable income on its Form 990-T, and paid the resulting \$B in unrelated business income tax.

The Trust filed an amended Form 990-T for the taxable year ending Date 1, in which it claimed a refund of the \$B paid in unrelated business income tax (the Amended Return).

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The IRS denied the refund claim, the Trust filed a Letter of Protest,<sup>41</sup> and the IRS Office of Appeals (Appeals) held a conference. In a letter dated \_\_\_\_\_ the Trust asked Appeals to request technical advice pursuant to Revenue Procedure \_\_\_\_\_. On \_\_\_\_\_ Appeals submitted a request for a technical advice pre-submission conference and a pre-submission conference was held on \_\_\_\_\_<sup>42</sup> Appeals subsequently submitted the request for technical advice through division counsel on \_\_\_\_\_<sup>43</sup>

## LAW AND ANALYSIS

### LAW

#### Statutory Construction

In Hardt v. Reliance Standard Life Insurance Co., 560 U.S. 242 (2010), the Supreme Court reiterated the long standing principle that an analysis of statutory language begins by assuming that the ordinary meaning of that language accurately expresses the legislative purpose.<sup>44</sup> The Court also reiterated that the plain and unambiguous statutory language must be enforced according to its terms.<sup>45</sup> These canons of statutory construction are generally referred to as the canons of ordinary meaning and ambiguity

But in King v. Burwell, 135 S. Ct. 2480 (2015), the Supreme Court noted that oftentimes the meaning or ambiguity of certain words or phrases may only become evident when placed in context.<sup>46</sup> The Court further noted that when deciding whether the language is plain, it must read the words in their context and with a view to their place in the overall statutory scheme.<sup>47</sup> This determination may include prior legislative consideration of the problem, the act's legislative history, operation, and administration.<sup>48</sup>

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<sup>42</sup> Rev. Proc. \_\_\_\_\_, \_\_\_\_\_, Section 6.

<sup>43</sup> Rev. Proc. \_\_\_\_\_, Section 7.

<sup>44</sup> 560 U.S. at 251 (2010), quoting Gross v. FBL Financial Services, 557 U.S. 167 (2009).

<sup>45</sup> 560 U.S. at 251 (2010), citing Carcieri v. Salazar, 555 U.S. 379 (2009); Jiminez v. Quarterman, 555 U.S. 113 (2009).

<sup>46</sup> 135 S.Ct. at 2489, quoting FDA v. Brown & Williams Tobacco Corp., 529 U.S. 120, 132 (2000).

<sup>47</sup> 135 S.Ct. at 2489, quoting FDA v. Brown & Williams Tobacco Corp., 529 U.S. 120, 133 (2000).

<sup>48</sup> 135 S. Ct. at 2492 (discussion of the Affordable Care Act's passage, citing Cannan, "A Legislative History of the Affordable Care Act: How Legislative Procedure Shapes Legislative History, 105 L. Lib. J. 131 (2013)); National Woodwork Manufacturers Association v. N.L.R.B., 386 U.S. 612 (1967).

In, Advocate Health Care Network, et. al. v. Stapleton, 581 U.S. \_\_\_, \_\_\_ (June 5, 2017) (Slip. op. at 9) the Supreme Court reiterated a cardinal principle of statutory construction, which requires courts to “give effect, if possible, to every clause and word of a statute.”<sup>49</sup>

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<sup>49</sup> See also United States v. Menasche, 348 U.S. 528, 538-539 (1955), quoting Inhabitants of Montclair Township v. Ramsdell, 107 U.S. 147, 152 (1883); See also Williams v. Taylor, 529 U.S. 362, 404 (2000) (J. O’Connor, concurring).





**Internal Revenue Code****Exemptions from Tax Under Section 501(a) and Subjection of Organizations Exempt under Section 501(a) to Certain Taxes**

Section 501(a) provides that an organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation unless such exemption is denied under section 502 or 503.

Section 501(b) provides that an organization exempt under section 501(a) shall be subject to tax to the extent provided in parts II, III, and VI of subchapter F, but (notwithstanding parts II, III, and VI of subchapter F) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

Section 501(c)(1) describes, "Any corporation organized under Act of Congress which is an instrumentality of the United States but only if such corporation –

(A) is exempt from Federal income taxes –

- (i) under such Act as amended and supplemented before July 18, 1984, or
- (ii) under this title without regard to any provision of law which is not contained in this title and which is not contained in a revenue Act, or

(B) is described in subsection (l).

### Imposition of the Unrelated Business Income Tax

Section 511(a)(1) imposes a tax on the unrelated business taxable income (as defined in section 512) of every organization described in section 511(a)(2) a tax computed as provided in section 11.

Section 511(a)(2)(A) imposes a tax on the unrelated business taxable income of any organization that is exempt from federal income tax by reason of section 501(a) except for a trust described in section 511(b) or an organization described in section 501(c)(1) (a corporation organized under Act of Congress which is an instrumentality of the U.S.)

Section 511(b)(1) imposes a tax on the unrelated business taxable income of every trust described in section 511(b)(2), computed as provided in section 1(e) [income tax on estates and trusts]. Section 511(b)(1) further provides that in making the computation for purposes of this section, the term “taxable income” as used in section 1 shall be read as “unrelated business taxable income” as defined in section 512.

Section 511(b)(2) provides that the tax imposed by section 511(a)(1) applies in the case of any trust which is exempt from taxation under subtitle A by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (section 641 and following, relating to estates, trusts, beneficiaries, and decedents).

Section 512(a)(1) states that the term “unrelated business taxable income” (UBTI) means the gross income derived by any organization from any unrelated trade or

business (as defined in section 513) regularly carried on by it, less the applicable deductions, and computed with the modifications in section 512(b).

Section 512(b)(1) excludes from UBTI, all dividends, interest, payments with respect to securities, loans (as defined in subsection (a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income.

Section 512(b)(4) states, in part, that in the case of “debt-financed property” (as defined in section 514) there shall be included as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1).

Section 512(c) provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in section 512(b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income. This is true regardless of whether the organization is a limited partner or only has a passive role in the management of the partnership.<sup>51</sup>

Section 513(a) provides that the term “unrelated trade or business” means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 514(a)(1) provides that in computing unrelated business taxable income under section 512, with respect to each debt-financed property, there shall be included as an item of gross income derived from an unrelated trade or business an amount that is the same percentage (but not in excess of 100 percent) of the gross income derived from the property during a taxable year as (A) the average acquisition indebtedness with respect to the property is to (B) the average amount of the property’s adjusted basis during the period it is held by the organization during such taxable year.

Section 514(b)(1) provides that the term “debt-financed property” means any property which is held to produce income and with respect to which there is acquisition indebtedness (as defined in section 514(c) of the Code) at any time during the taxable year.

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<sup>51</sup> See *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980); 675 F.2d 244 (9<sup>th</sup> Cir. 1995); *Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner*, 724 F.2d 519 (6<sup>th</sup> Cir.1983), *affg.*, 78 T.C. 812 (1982).

Section 514(b)(1)(A)(i) excludes from the definition of “debt-financed property” any property substantially all the use 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 the purpose or function constituting the basis for its exemption under section 501.

Section 514(c)(2) provides that where property is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization did not assume or agree to pay such indebtedness.

Section 1.512(c)-1 of the Treasury Regulations provides that in the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto.

Section 1.512(c)-1 of the Treasury Regulations also includes an example which illustrates how UBTI is calculated in a situation in which an exempt organization receives partnership income that is UBTI and partnership income that is not UBTI from the same partnership. In the example, an exempt organization is a partner in a partnership that operates an unrelated business and holds stock in a corporation. The example illustrates that the exempt organization must include its share of the gross income from the unrelated business in computing its UBTI but not its share of any dividends as that income is excluded from UBTI under section 512(b)(1).

Section 1.513-1(d)(1) of the Treasury Regulations provides that gross income derives from an “unrelated trade or business” within the meaning of section 513(a) of the Code if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

Section 1.513-1(d)(2) of the Treasury Regulations provides that a trade or business is “related” to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is “substantially related” only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 1.514(b)-1(b)(1)(i) of the Treasury Regulations provides that to the extent that the use of any property is substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting its basis for exemption under section 501 of the Code, such property shall not be treated as “debt-financed property.” It further directs the reader to see section 1.513-1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

Section 1.514-1(b)(1)(ii) of the Treasury Regulations provides that if substantially all of any property is used in the manner described in subdivision (i), such property is not treated as debt-financed property. In general, the preceding sentence applies if 85 percent or more of the use of such property is devoted to the organization’s exempt purpose. The extent to which property is used for a particular purpose shall be determined on the basis of all the facts and circumstances.

Section 1.514-1(b)(1)(ii) includes Example 2, which illustrates the application of the rules for determining whether a given property is debt-financed property. In the example, an exempt college owns a four story office building which has been purchased with borrowed funds. The gross income derived from the building is \$6,000 all of which is attributable to rents paid by tenants. The bottom two stories of the building are used to house computers which are used by the college for administrative purposes. The top two stories are rented to the public for purposes not described in §514(b)(1)(A), (B), (C), or (D). The example states that in accordance with §1.514-1(b)(1)(i), the bottom half of the building is used in a manner that is substantially related to the college’s exempt purpose (aside from the college’s need for funds). Thus, only the upper half of the building is debt-financed property.

Section 1.514(c)-1(a)(2) cites an example (Example (4)) of an exempt organization which enters into a partnership with two individuals. The business of the partnership involves an office building which is leased to the public. With respect to the character of any item realized by the partnership and included in a partner’s distributive share, the example points out that the particular item shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner.

Rev. Rul. 79-222, 1979-2 C.B. 236, holds that the investment of an exempt employees’ trust as a limited partner in a partnership carrying on an unrelated trade or business may result in unrelated business taxable income within the meaning of section 512 of the Code.

In Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner, 724 F.2d 519 (6th Cir.1983), confirming the IRS’s position in Rev. Rul. 79-222, the Sixth Circuit affirmed the Tax Court’s decision that a tax-exempt limited partner was taxable under sections

512(c) and 513(b)(2) on income derived from a partnership in the same manner as if it were a general partner.<sup>52</sup>

Rev. Rul. 74-197, 1974-1 C.B. 143, held that the investment by an exempt employees' trust in a partnership that was organized to invest in securities and borrowed funds for that purpose resulted in unrelated business taxable income to the extent its share of partnership income was derived from or on account of the debt-financed securities.

Rev. Rul. 77-72, 1977-1 C.B. 157, citing legislative history, states that the intent of section 514 of the Code is to treat an otherwise exempt organization in the same manner as an ordinary business enterprise to the extent that the exempt organization purchases property through the use of borrowed funds.<sup>53</sup> The legislative history indicates that the purpose of the acquisition indebtedness provisions of section 514 of the Code was to "...discourage a developing device for trading in the tax exemption of nonprofit organizations, which now escapes unrelated business income tax." The Report stated that "[d]uring the past several years a device has been developing which exploits these weaknesses in the taxation of unrelated business income of tax-exempt organizations. The net effect is the use of the tax exemption to reduce taxes for owners of a business by converting ordinary income to capital gain and eventually to acquire a business for a tax-exempt organization entirely out of the earnings of that business." The committee indicated that it believed that "[t]his type of transaction with its damaging consequences to the Federal revenues as well as its potential for unfair business competition should be discouraged."

In Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347 (3rd Cir. 1980), the court concluded that a section 401(a) profit-sharing plan's purchase of securities on margin constituted debt-financed property and income derived from the securities was taxable as unrelated business income. The purchase of such securities on margin was not substantially related (aside from the need of the organization for income or funds) to the performance of the plan's exempt purpose of providing deferred compensation because purchasing securities on margin was only "a means to accomplish the purpose of deferred compensation[,] ... not the purpose itself of the Plan."<sup>54</sup>

In Alabama Central Credit Union v. United States, 646 F. Supp. 1199 (N.D. Ala. 1986), the court held that the securities bought on margin with borrowed funds in order to maximize yield or income was debt-financed property within the meaning of section 514. The indebtedness incurred in the purchase of the securities constituted "acquisition indebtedness," as defined in section 514(c). Additionally, the transactions did not fall within the exception for debt incurred in performing an exempt purpose set forth in section 514(c)(4), because the securities purchases were not inherent in the performance or exercise of the credit union's tax-exempt function, but rather were

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<sup>52</sup> 78 T.C. 812 (1982).

<sup>53</sup> H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 46 (1969), 1969-3 C.B. 200, 230; H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 46 (1969); 1969-3 C.B. 200, 228-230.

<sup>54</sup> 614 F.2d at 350.

undertaken in order to obtain favorable return on investment money. Therefore, the proceeds were properly characterized as unrelated business income taxable under section 512(b)(4). The credit union was permitted to make such investments, but the income derived from them was taxable.

In Ocean Cove Corporation Retirement Plan and Trust v. United States, 657 F. Supp. 776 (S.D. Fla. 1987), the court found that securities purchased on margin by a section 401(a) pension plan constituted debt-financed property and therefore income derived from the securities was taxable as unrelated business income. Such securities were not property substantially all the use of which was substantially related (aside from the need of the organization for income or funds) to the performance of the plan's exempt purpose because the exempt "purpose of a pension retirement plan is to provide for the future retirement of existing employees" and "[i]nvesting in securities, particularly those that are purchased on margin, is merely one way of accomplishing th[ose] intended purposes."<sup>55</sup>

In Kern County Electrical Pension Fund v. Commissioner, 96 T.C. 845 (1991), aff'd, 988 F.2d 120 (9th Cir. 1993), the court concluded that the exempt trust of a section 401(a) employee pension plan had to pay UBIT on interest earned on certificates of deposit purchased with borrowed funds because the interest qualified as debt-financed income.

In Henry E. & Nancy Horton Bartels Trust for the Benefit of University of New Haven v. United States, 209 F.3d 147 (2d Cir. 2000), the court considered a tax-exempt trust that engaged in investment activities, including the purchase of securities on margin, to provide support for a university. The court determined that the purchase of such securities was not substantially related (aside from the need of the organization for income or funds) to the performance of the plan's exempt purpose because the taxpayer's exempt purpose was not to invest but rather to provide funds to support the university's educational programs.

In Henry E. & Nancy Horton Bartels Trust for the Benefit of Cornell University v. United States, 617 F.3d 1357 (Fed. Cir. 2010), the court considered another tax-exempt trust that invested by purchasing securities on margin, to provide support for a university. To begin, the court observed that sections 512(b)(4) and 514(a) together define an additional category of UBTI, debt-financed property, which is accordingly subject to UBIT. The court further observed that for debt-financed property, "section 514 nullifies section 512(b)'s general exemption of dividends, interest, royalties, and the like from UBIT."<sup>56</sup> With respect to the trust at hand, the court determined that securities purchased on margin (money borrowed from the trust's broker to complete the stock purchases) constituted debt-financed property and, therefore, income derived from the purchase of securities on margin constituted UBTI.

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<sup>55</sup> 657 F. Supp. at 779-80.

<sup>56</sup> Bartels Trust for the Benefit of Cornell University v. U.S., 617 F.3d 1357, 1360 (Fed. Cir. 2010).



In Southwest Texas Electric Coop. v. Commissioner, T.C. Memo 1994-363, aff'd, 67 F.3d 87 (5<sup>th</sup> Cir. 1995), the court held that Treasury notes acquired with tax-exempt bond proceeds were not substantially related to the organization's exempt purpose. The court reasoned that the indebtedness used to purchase Treasury notes would not have been incurred except to purchase them.

## **ANALYSIS**

### **I. The Trust is Subject to UBIT**

#### **A. The Trust is Exempt from Federal Income Tax Under Section 501(a) and Subject to Unrelated Business Income Tax Under Section 501(b)**

Section 501(a) provides for exemption from federal income taxes for an organization described in subsection (c) or (d) or section 401(a). Statutory language which is plain and unambiguous language such as the language in section 501(a) must be enforced according to its terms.<sup>57</sup> Because the Trust is \_\_\_\_\_, it is an organization described in section 501(c). Therefore, section 501(a) exempts the Trust from federal income tax.

Section 501(b) provides in relevant part that an organization exempt from tax under section 501(a) shall be subject to tax to the extent provided in parts II, III, and VI of subchapter F. Section 501(b)'s language is also plain and unambiguous in its subjection of organizations exempt from tax under section 501(a) to tax under parts II, III, and VI of subchapter F.<sup>58</sup> Accordingly, section 501(b) must be "enforced" according to its terms.<sup>59</sup>

Part III of subchapter F is entitled "Taxation of business income of certain exempt organizations." Part III lists its sections as follows:

Section 511	Imposition of tax on unrelated business income of charitable, etc. organizations.
Section 512	Unrelated business taxable income.
Section 513	Unrelated trade or business.
Section 514	Unrelated debt-financed income.
Section 515	Taxes of foreign countries and possessions of the United States

<sup>57</sup> Hardt v. Reliance Standard Life Ins. Co., 560 U.S. at 251 (2010), citing Carcieri v. Salazar, 555 U.S. 379 (2009); Jiminez v. Quarterman, 555 U.S. 113 (2009).

<sup>58</sup> Hardt v. Reliance Standard Life Ins. Co., 560 U.S. at 251 (2010), citing Carcieri v. Salazar, 555 U.S. 379 (2009); Jiminez v. Quarterman, 555 U.S. 113 (2009).

<sup>59</sup> Hardt v. Reliance Standard Life Ins. Co., 560 U.S. at 251 (2010), citing Carcieri v. Salazar, 555 U.S. 379 (2009); Jiminez v. Quarterman, 555 U.S. 113 (2009).

As a general matter, section 501(b) unambiguously subjects the Trust to tax in part III of subchapter F because the Trust is an organization exempt from tax under section 501(a).<sup>60</sup> Because Part III includes imposition of the unrelated business income tax (sections 511 – 514), the Trust is generally subject to the unrelated business income tax (UBIT).

B.

Section 511(a)(2)(A) applies UBIT to any organization that is exempt from federal income tax by reason of section 501(a) except for a trust described in section 511(b) or an organization described in section 501(c)(1). As discussed further below, the Trust is subject to UBIT under section 511(b).

To be exempt under section 501(c)(1)(A) or (B), the organization must first be, “a corporation organized under Act of Congress which is an instrumentality of the United States.”

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<sup>60</sup> Hardt v. Reliance Standard Life Ins. Co., 560 U.S. at 251 (2010), citing Carcieri v. Salazar, 555 U.S. 379 (2009); Jiminez v. Quarterman, 555 U.S. 113 (2009).

<sup>61</sup> See Hardt v. Reliance Standard Life Ins. Co., 560 U.S. at 251 (2010), citing Carcieri v. Salazar, 555 U.S. 379 (2009); Jiminez v. Quarterman, 555 U.S. 113 (2009).

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### C. Section 511(b) Imposes UBIT on the Trust,

#### 1. Section 511(b)(2) Imposes UBIT on the Trust

Section 511(b)(2) of the Code imposes UBIT on the Trust. Section 511(b)(2) provides that the tax imposed by section 511(b)(1) applies in the case of any trust which is exempt from taxation under subtitle A by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents). The plain and unambiguous language in section 511(b)(2) imposes UBIT on a trust that is exempt from taxation under subtitle A by reason of section 501(a) and, if it were not for that exemption, would be subject to subchapter J. Accordingly, the language in section 511(b) must be “enforced” according to its terms.<sup>66</sup>

As discussed above, the Trust is exempt from tax under subtitle A by reason of section 501(a). Thus, it satisfies this first requirement to be subject to UBIT under section 511(b)(2).

Second, the Trust would be subject to subchapter J (sec. 641 and following) were it not for its exemption . Section 641 in relevant part applies the tax imposed by section 1(e) to the taxable income “of any kind of property held in trust.” Because the Trust

the Trust would be subject to subchapter J were it not for its exemption Thus, it satisfies the second requirement and is subject to UBIT by direct application of section 511(b)(2).

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<sup>66</sup> *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. at 251 (2010), citing *Carcieri v. Salazar*, 555 U.S. 379 (2009); *Jiminez v. Quarterman*, 555 U.S. 113 (2009).

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D.

Generally, tax exemptions are matters of legislative grace that must be narrowly construed and unambiguously proven.<sup>69</sup>

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<sup>69</sup> See, e.g., United States v. Wells Fargo Bank, 485 U.S. 351, 354 (1988); Bingler v. Johnson, 394 U.S. 741, 752 (1969); New Colonial Ice v. Helvering, 292 U.S. 435, 440 (1934); and Kile v. Comm'r, 739 F. 2d 265, 268 (7<sup>th</sup> Cir. 1984).

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<sup>86</sup> Advocate Health Care Network, 581 U.S. \_\_\_, \_\_\_ (June 5, 2017) (Slip. op. at 9); Corley v. U.S., 556 U.S. 303 (2009); Moneygram International, Inc. and Subsidiaries v. Commissioner, 118 A.F.T.R.2d 2016-6652.

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However, Congress provided exemption from federal income tax and UBIT for these organizations under sections 501(c)(1) and 511(a)(2)(A).

#### E. Conclusion of Part I

Section 501 subjects the Trust to UBIT and section 511 imposes the tax on the Trust.

is subject to UBIT.

Therefore, the Trust

II. The Trust's Activities, with Respect to Partnerships and Debt-Financed Property, Are Not Substantially Related to its Exempt Purpose

Section 513 of the Code provides that income from a trade or business operated by an exempt organization is UBTI to the exempt organization unless the trade or business is substantially related to the exempt purpose of the exempt organization. With respect to a partnership in which an exempt organization is a member, the trade or business operated by the partnership must be substantially related to the exempt purpose of the organization in order for the exempt organization's income from the partnership that is attributable to the trade or business of the partnership to be exempt from UBIT.

With respect to property purchased with debt, section 514 of the Code automatically treats income from such property as income from an unrelated trade or business unless substantially all of the use of the property is substantially related to the exempt purpose of the organization. The same rule applies to the extent that an exempt organization is a member of a partnership that holds property purchased with debt.<sup>94</sup>

Because these analyses begin with the organization's exempt purpose, establishment of that purpose is a crucial first step.

A. Exempt Purpose

Because the treatment of the Trust's income from partnerships and debt-financed property – i.e., whether or not such income is UBTI – depends upon whether there is a substantial relationship between the Trust's exempt purpose and the businesses of the partnerships, or the use of the property, it is essential to establish what the Trust's exempt purpose is.

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<sup>94</sup> IRC §512(c); Treas. Reg. §1.512(c)-1; Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner, 724 F.2d 519 (6<sup>th</sup> Cir. 1983); Rev. Rul. 79-222, 1979-2 C.B. 236.

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More specifically, in the context of partnerships, section 513(a) requires a “substantial relationship” between the businesses of the partnerships in which the Trust holds membership interests and the exempt purpose of the Trust,

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, in order to avoid UBIT.<sup>97</sup> In the context of debt-financed property, section 514(b) requires that substantially all of the use of the property be substantially related to the Trust's exempt purpose, aside from the Trust's need for income or funds.<sup>98</sup>

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<sup>97</sup> IRC §513(a).

<sup>98</sup> IRC §514(b).

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B. The Trust's Activities, with Respect to Partnerships and Debt-Financed Property, Do Not Satisfy the Substantial Relationship Tests Under Sections 513 and 514 of the Code

1. The Substantial Relationship Tests of Sections 513 and 514 of the Code

a. The Substantial Relationship Test of Section 513

Section 513(a) of the Code excludes conduct that merely meets, “the need of [an] organization for income or funds” from being considered “substantially related” to that organization’s exempt purpose or function.<sup>104</sup> The substantial relationship must be established aside from the need of the organization for income or funds or the use it makes of the profits derived from the trade or business.<sup>105</sup> Section 1.513-1(d)(2) of the regulations states that a trade or business is substantially related to an organization’s exempt purposes only where the conduct of the business activities has a substantial causal relationship to the achievement of those purposes – other than through the production of funds – and contributes importantly to the accomplishment of those purposes.

b. The Substantial Relationship Test of Section 514

With respect to section 514, section 514(a)(1) automatically treats income from debt-financed property as income derived from an unrelated trade or business. Section 514(b)(1)(A)(i) provides that debt-financed property does not include, “any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance” of its exempt purpose.<sup>106</sup> The relevant sections of the Code and the Treasury Regulations

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<sup>104</sup> IRC §513(a); Treas. Reg. §1.513-1(d)(1).

<sup>105</sup> IRC §513(a); Treas. Reg. §1.513-1(d)(1).

<sup>106</sup> IRC § 514(b)(1)(A)(i).

unanimously provide that a trade or business is related to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes other than through the production of income. Otherwise, such property is “debt-financed property” under section 514(b).

In the context of income from property acquired with debt, the Treasury Regulations provide that at least 85% of each relevant property must be used in a manner that is substantially related to the Trust’s exempt purpose or function, aside from the Trust’s need for income or funds.<sup>107</sup> For example, the portion of an office building purchased with borrowed funds by an exempt college and used to house computers which are used by the college for administrative purposes, would not be debt-financed property.<sup>108</sup> But the portion of that office building used simply to generate income, such as rental income, would be debt-financed property.<sup>109</sup>

### c. Sections 513 and 514 in the Context of Partnerships

In general, exempt organizations may serve as general or limited partners in a partnership, as long as certain parameters are met.<sup>110</sup> For UBIT purposes, income an exempt organization derives from participation in general or limited partnerships is not taxable as UBTI if the trade or business of the partnership is substantially related to the organization’s exempt purpose.<sup>111</sup> Because partnerships are pass-through entities,<sup>112</sup> the activity of the partnership is attributed to the exempt organization as if the exempt organization were conducting the activity itself in situations in which an exempt organization is a general or limited partner.<sup>113</sup> If the organization receives income from the trade or business of a partnership that is not substantially related to the organization’s exempt purpose, then that income is taxable as UBTI.<sup>114</sup> Similarly, if the organization receives income from debt-financed property that it holds directly or through a partnership and substantially all the use of that property is not substantially related to the organization’s exempt purpose, then that income is taxable as UBTI.<sup>115</sup>

According to the requirements of sections 513 and 514 described above, we address the issue of whether there is a substantial relationship between the Trust’s exempt purpose

<sup>107</sup> IRC § 514(b)(1)(A)(i); Henry E. & Nancy Horton Bartels Trust for the Benefit of University of New Haven, 209 F.3d 147, 155 (2<sup>nd</sup> Cir. 2000); Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F. 2d 347, 350 (3rd Cir. 1980); Southwest Texas Elec. Co-op., Inc. v. Commissioner, T.C. Memo 1994-363 (1994).

<sup>108</sup> Treas. Reg. § 1.514-1(b)(1)(ii) (Example 2).

<sup>109</sup> Treas. Reg. § 1.514-1(b)(1)(ii) (Example 2).

<sup>110</sup> See generally Plumstead Theatre, Service Bolt & Nut; Rev. Rul. 98-15, 1998-1 C.B. 718.

<sup>111</sup> IRC §§ 512(c), 513(a); Treas. Reg. §§ 1.513-1(d)(1) and (2); Plumstead Theatre, Service Bolt & Nut; Rev. Rul. 98-15.

<sup>112</sup> IRC § 512(c); Treas. Reg. § 1.512(c)-1; Plumstead Theatre and Service Bolt & Nut.

<sup>113</sup> IRC § 512(c); Treas. Reg. §§ 1.512(c)-1, 1.514(c)-1(a)(2); Plumstead Theatre, Service Bolt & Nut; Rev. Rul. 98-15.

<sup>114</sup> IRC § 512(c).

<sup>115</sup> IRC §§ 512(b)(4), 512(c), 514(a), 514(b)(1)(A)(i); Rev. Rul. 79-222.



and the businesses of the partnerships in which it holds interests. Likewise, we address whether there is a substantial relationship between the Trust's exempt purpose and the use of any debt-financed property it holds directly or indirectly through a partnership.<sup>116</sup>

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a. Detailed Review of the Relevant Facts

The Trust has indicated that the \$A of income on which it paid UBIT for the tax year ending Date 1, was income from partnerships in which the Trust held membership interests and debt-financed assets.<sup>117</sup>

On its Original Return, the Trust reported \$A of UBTI from LP 1.<sup>118</sup> It paid UBIT of \$B on this UBTI.

LP 1<sup>119</sup>

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On its Amended Return, the Trust reported income from LP 1, LP 2, and LP 3.<sup>121</sup> LP

The Trust stated its belief that income earned from [redacted] was not UBTI because the [redacted] activities giving rise to the income were substantially related to the Trust's exempt purpose. But the Amended Return did not explain how the businesses of the partnerships [redacted]

[redacted] were substantially related to the Trust's exempt purpose [redacted].

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LP 1, LP 2, or LP 3.<sup>122</sup>  
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Year 1

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Year 1

the Trust stated that  
investing in certain debt-financed assets and partnership interests contributes  
importantly to the achievement of the Trust's exempt purpose  
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LP 1, LP 2, and LP 3

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To the extent that the partnerships in question hold debt-financed property the Trust has not met the requirement of section 514(b)(1)(A)(i) because it has not shown that the use of its debt-financed properties is substantially related to the achievement of its exempt purpose

c. In Addition to the Code and the Treasury Regulations, the Case Law Makes Clear that a Substantial Relationship Must be Established

The only relationship between the Trust's exempt function and the businesses of the partnerships, and the use of properties purchased with debt, appears to be

In addition to the Code and the Treasury Regulations, the case law makes clear that such a relationship is insufficient for activities to be considered substantially related to the purposes of section 501(c) organizations or trusts exempt from tax under section 501(a)

For example, courts have determined that for purposes of section 514, the exempt purpose of a qualified retirement trust is not to invest assets but to provide retirement

benefits or deferred compensation.<sup>131</sup> Thus, courts have rejected the argument that the purchase or use of debt-financed investments is substantially related to the exempt purpose of qualified retirement trusts and other exempt organizations that manage and invest assets to support the program of separate organizations.<sup>132</sup>

<sup>133</sup> The IRS reached a similar conclusion in Rev. Rul. 74-197 in which it held that the investment property acquired by an exempt employees' trust through a partnership that borrowed funds to invest in the property was not substantially related (aside from the need of the trust for funds) to the organization's exempt purpose.

but courts have held that the exempt purpose of entities was to support the program of the separate organization, and the activities were just a means to that end. For example, in Henry E. & Nancy Horton Bartels Trust for the Benefit of University of New Haven, the Second Circuit considered a tax-exempt trust that engaged in activities including the purchase of securities on margin to provide support for a university. The court determined that the taxpayer's exempt purpose was not to invest but rather to provide funds to support the university's educational programs. While margin-financed securities "may be useful to accomplish that exempt purpose by their ability to generate income," the court concluded that "their purchase and use was not otherwise substantially related to the taxpayer's tax-exempt purpose."<sup>134</sup>

Similarly, in Elliot Knitwear Profit Sharing Plan v. Commissioner, the Third Circuit found that the taxpayer's purpose was not investing but, "to provide for employee participation in the profits of the employer."<sup>135</sup> The court stated that investment for the additional accumulation of income and gains is certainly a "desirable function" of a profit-sharing plan, but that the plan's purpose could be accomplished without borrowing.<sup>136</sup> Accordingly, the court rejected the taxpayer's argument that the purchase of securities on margin was substantially related to the organization's exempt purpose.<sup>137</sup>

<sup>131</sup> Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347, 350 (3rd Cir. 1980); Ocean Cove Corporation Retirement Plan and Trust v. United States, 657 F. Supp. 776, 779-780 (S.D. Fla. 1987); Kern County Electrical Pension Fund v. Commissioner, 96 T.C. 845, 853 (1991).

<sup>132</sup> Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. U.S., 209 F.3d 147, 155-156 (2<sup>nd</sup> Cir. 2000); Ocean Cove Corp. Retirement Plan and Trust v. U.S., 657 F. Supp. 776, 779-780 (S.D. Fla. 1987); Alabama Central Credit Union v. U.S., 646 F. Supp. 1199, 1205 (1986).

<sup>133</sup> Ocean Cove Corp. Retirement Plan and Trust v. U.S., 657 F. Supp. 776, 780 (S.D. Fla. 1987).

<sup>134</sup> 209 F.3d at 156.

<sup>135</sup> 614 F.2d at 350.

<sup>136</sup> 614 F.2d at 350. See also Ala. Cent. Credit Union v. United States, and Southwest Tex. Elec. Coop. v. Commissioner.

<sup>137</sup> Elliot Knitwear, 614 F.2d at 350.

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the businesses of the partnerships are not substantially related under section 513(a) and the use of the properties does not meet the requirements of section 514(b)(1)(A)(i).

Citing legislative history, Rev. Rul. 77-72 states that the intent of section 514 is to treat an otherwise exempt organization in the same manner as an ordinary business enterprise to the extent that the exempt organization purchases property through the use of borrowed funds. Congress has seen fit to treat the Trust in the exact same manner as the trust in Rev. Rul. 74-197 that was subject to UBIT on debt-financed income. Rev. Rul. 74-197 cites legislative history for the proposition that section 514 cannot be circumvented where investment property is also acquired and the borrowing would not have occurred but for the investment property acquisition.<sup>144</sup>

While activities constitute at least a part of the activities of arguably all section 501(c) exempt organizations and

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<sup>140</sup> Ocean Cove Corp. Retirement Plan and Trust v. U.S., 657 F. Supp. 776 (S.D. Fla 1987).

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<sup>144</sup> Rev. Rul. 74-197, citing Senate Report No. 91-552 (1<sup>st</sup> Session), 1969-3 C.B. 423, at page 465.

sometimes the major part of these organizations' activities, that fact in itself does not render the UBIT rules superfluous. Rather, the UBIT rules apply to section 501(c) organizations including the Trust,

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<sup>145</sup>

<sup>146</sup> Ocean Cove Corp. Retirement Plan, 657 F. Supp. at 779.

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## C. Conclusion – Part II

The Trust's exempt purpose

The Trust holds interests in partnerships, including partnerships that hold debt-financed property. The only relationship between the Trust's exempt purpose and the businesses of the partnerships, and the use of property purchased with debt,

Because such a relationship is not sufficient for purposes of sections 513 and 514, income from the partnerships or from property purchased with debt, is UBTI to the Trust.

### CONCLUSION(S):

- (1) The Trust is subject to unrelated business income tax.
- (2) The Trust's activities, with respect to partnerships and debt-financed property, are not substantially related to the Trust's exempt purpose.

### CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.