

NONPROFIT FORUM

Some Thoughts on the Unrelated Debt-Financed Income  
Provisions of the Unrelated Business Income Tax

Jonathan A. Small\*

November 26, 1997

---

\* Copyright© 1997 by Jonathan A. Small.  
All rights reserved.

Some Thoughts on the Unrelated Debt-Financed Income  
Provisions of the Unrelated Business Income Tax

by Jonathan A. Small\*

Sections 511 through 514 of the Internal Revenue Code of 1986 subject not-for-profit organizations to the Unrelated Business Income Tax (UBIT).<sup>1</sup> This tax is imposed when such organizations report profits attributable either to "unrelated" business activities or to "debt-financed" income. The rationale behind this tax derives from the relation between tax-exempt organizations and the overall scheme of federal taxation.

The fundamental structure of the UBIT reflects a tension between two basic principles guiding tax policy in the not-for-profit area. On the one hand, a general tax

---

\* The help of Jonathan Boyarin and Ariella Reback in the preparation of this paper is gratefully acknowledged.

1. The following acronyms are frequently used in UBIT discussions: (a) UBTI stands for "unrelated business taxable income," meaning income that is subject to tax because it is derived from activities treated as unrelated to the tax-exempt's basic organizational purpose; and (b) UDFI is "unrelated debt-financed income," which is treated as a particular form of UBTI.

exemption is justified on the grounds that section 501(c)(3) not-for-profits provide services which otherwise might be provided by government.<sup>2</sup> On the other hand, the UBIT regime is intended to curb, insofar as feasible, the possibility of "unfair competition" with taxable private businesses. In the famous *Mueller Company* case, New York University School of Law became the owner of what was then the largest manufacturer of noodles in the United States. Upon acquisition, the company's purpose was rewritten to state that all of the profits were to be devoted to funding the Law School's operations. The Third Circuit upheld the company's exemption from taxes, stating that under the law in effect before 1950, "[t]he policy . . . [was] that the benefit from revenue is outweighed by the benefit to the general public welfare gained through the encouragement of charity."<sup>3</sup>

---

2. Different rationales underlie the exempt status of other section 501(c) organizations; this paper focuses on section 501(3)(3) organizations.

3. *C.F. Mueller Company v. Commissioner of Internal Revenue*, 190 F.2d 120, 122 (1951).

In response to this funding strategy, Congress expressed serious concern that tax-exempt owners of unrelated businesses would gain sufficient competitive advantage that they would drive taxpaying competitors out of business.<sup>4</sup> "Representative Dingell warned, '[I]f something is not done . . . the macaroni monopoly will be in the hands of the universities . . . .'"<sup>5</sup> Whether this was a realistic fear or something to be feared at all may be questioned. In any case, "unfairness" too is in the eye of the beholder.<sup>6</sup>

The established framework of the UBIT received sustained legislative scrutiny in the mid-1980s, following

- 
4. Congressional hearings produced descriptions of "universities . . . engaged in the manufacture of automobiles and chinaware and in the operation of theaters and oil wells." *US v. American College of Physicians*, 475 U.S. 834, 838, 106 S.Ct. 1591, 89 L.Ed. 841 (1986).
  5. Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 *Harvard L. Rev.* 1280, 1281 (1968).
  6. "[D]istinctions between types of activity are often rather artificial . . . . exempt organizations may perform the same functions as commercial businesses, and their managers may be as personally interested in the activity. Only a social judgment that the exempt activity is worth subsidizing differentiates the two." *Id.* at 1292.

recommendations of increased I.R.S. auditing in this area and a Small Business Administration report documenting numerous cases evidencing business activity by exempt organizations that could have been run by for-profit businesses.<sup>7</sup> However, more than a decade later, no significant legislation has resulted from this flurry of Congressional attention, although the UBIT rules have been amended to deal with certain concerns. (See, e.g., section 512(b)(17), treating as UBTI a portion of the "controlled foreign corporation" inclusions derived by US tax-exempts from investments in non-US insurance companies.) This might well indicate a certain acquiescence on the part of Congress; evidently there is no public outcry demanding reform of the UBIT regime, nor is there serious lobbying pressure from the business community.

However, the combination of increased pressure on tax-exempts to find alternative sources of income to

---

7. See Treusch, *Tax-Exempt Charitable Organizations* 407 (3rd Ed. 1988). A typical example was the sale of Apple computers at a large discount by the University of Michigan to its faculty and students.

government support, combined with legislative pressures to fund tax cuts without overall loss of revenue or deficit increases, could lead to renewed scrutiny of the UBIT rules. In any case, the reduction of governmental support for public charities beginning in the 1980s and continuing into the present, along with a general political atmosphere favoring increased privatization, has led exempt organizations to look toward profitable unrelated ventures.<sup>8</sup>

Current statistics suggest that exempts are not only seeking, but finding, alternative sources of income. Tax-exempts paid just over half a billion dollars in UBIT in 1996, an increase of 70% from 1994. Interpreting this jump, Marcus Owens, director of the Exempt Organizations group at the I.R.S., cited "heightened I.R.S. audit emphasis and educational efforts," as well as prominent court decisions. Beyond these effects of presumed greater scrutiny and

---

8. *Id.* at 416-421.

reporting, however, Owens also suggested that exempt organizations may actually have greater amounts of UBIT.<sup>9</sup>

The framework for the UBIT regime has been in place since the Revenue Act of 1950,<sup>10</sup> and has remained essentially the same since 1969. UBIT is set forth in sections 511 through 515 of the Internal Revenue Code.

Section 511 generally provides that the unrelated business taxable income of most organizations otherwise exempt from taxation under section 501(a) will be treated as ordinary taxable income of a corporation, subject to taxation at the corporate rates specified in section 11. Similarly, certain charitable and other trusts are taxed at the rates applicable to trusts and estates, as specified in section 1.

Section 512 defines "unrelated business taxable income" as "the gross income derived by any organization from any unrelated trade or business . . . regularly carried

---

9. "Tax Report," Wall Street Jrnl. June 18, 1997, at A1.

10. See U.S. v. American College of Physicians, *supra*, note 4, at 837.

on by it." Deductions analogous to those permitted for fully taxable organizations are permitted under section 512, but only insofar as the deductions are directly connected with carrying on the unrelated trade or business.<sup>11</sup> Perhaps most importantly, section 512(b) states that passive investment income, rental income and gains or losses from the sale of non-inventory property will not be subject to the UBIT.

Section 513 defines "unrelated trade or business" as:

[A]ny 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

---

11. See Treusch, *supra* note 7, at 396. As Treusch notes, this can be a disadvantage compared to the situation of fully taxable organizations, which enjoy greater flexibility in using losses from one activity to offset profits from another.



function constituting the basis for its  
exemption . . .<sup>12</sup>

Section 513 then lists a number of exceptions to this definition. These exceptions include income derived from volunteer labor, income from activities carried out for the convenience of an organization's members or other constituents, and income from the sale of donated merchandise.<sup>13</sup> Further specified exceptions, ranging from provisions of certain hospital services<sup>14</sup> to bingo games,<sup>15</sup> indicate the somewhat arbitrary nature of the "substantially unrelated" test and reflect the political history of these sections.

In terms of understanding the logic of the UBIT, the importance of section 513 derives chiefly from the two words "substantially related" and the parenthetical phrase

---

12. This definition conforms to the notion of "trade or business" contained in section 162 of the Code, which provides for the deductibility of "trade or business expenses." Treas. Regs. § 1.513-1(b).

13. I.R.C. § 513(a)(1)-(3).

14. I.R.C. § 513(e).

15. I.R.C. § 513(f).

that follows them to the effect that "relatedness" is not derived simply from the need for funds. The Regulations state that, in order for a trade or business to be "substantially related," its activities must "contribute importantly to the accomplishment" of the organization's tax-exempt purposes.<sup>16</sup> This vague standard is again reflected in the statement that whether a given trade or business is in fact "substantially related" to a given organization's tax-exempt purpose depends on the facts and circumstances of each case.<sup>17</sup> The parenthetical phrase following "substantially related" makes clear that substantially related status will not be found merely because the organization uses the profits in question to advance its exempt purpose. To put it another way, the ends do not exempt the means.

The switch to a "source-of-income" test for the determination as to whether income is related to the organization's exempt purposes serves as a limited check on

---

16. Treas. Reg. § 1.513-1(d)(2).

17. *Id.*

the growth and power of the private not-for-profit sector. Dating from the Revenue Act of 1950, it represents a rejection of the earlier "destination of income test," which permitted business income to be exempt where it was put to use in performing exempt purposes.<sup>18</sup>

Under the UBIT regime, the "source of income" test makes possible taxation of some of the income of an exempt organization without risking the loss of that organization's exempt status. In essence, the UBIT regime effects a surgical segregation of a tax-exempt organization's "unrelated business" activities from its other activities. Thus a "substantial part" of an exempt organization's activities may be devoted to an unrelated business, as long

---

18. See *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924) (articulating the destination of income test) (holding that where a religious order used properties otherwise "held for religious, charitable and educational purposes" to produce income which was in turn devoted to these same purposes, such income was not taxable).

as those activities do not constitute its "primary purpose."<sup>19</sup>

Section 514, discussed below, covers the category of UBTI designated as "unrelated debt-financed income" ("UDFI"). In essence, it states that income which otherwise would be exempt from tax as derived from passive investments will be treated as UBTI if that income is derived from "debt-financed property." The reach of section 514, which originally focused on the debt-financing aspect of bootstrap sale-leaseback transactions, has grown to cover most passive unrelated investments to the extent that their acquisition is debt-financed. Now, "the crucial question is simply whether the property that produced the income would have been acquired 'but for' the debt-financing, determined as provided in Section 514."<sup>20</sup>

---

19. Treas. Regs. § 1.501(c)(3)-1(e).

20. Treusch, *supra* note 7, at 381.

Unrelated Debt-Financed Income (UDFI) -- Background and Rationale

The treatment of unrelated debt-financed income as a tax issue is derived originally from concerns about "sale-leaseback" arrangements, whereby an exempt organization could purchase business property (such as a manufacturing company or a piece of real estate), lease the property to its previous owner-manager and finance the property through the ongoing profits or rents. The seller-lessee was able to deduct these payments as "rent," while the exempt organization did not pay tax on its corresponding income.

This type of transaction was mutually profitable because, in the absence of tax on UDFI, the exempt organization-purchaser owed no taxes on income derived from the business, while the former owner-seller could treat installment payments received from the sale of the business as capital gains, rather than as ordinary income.

Congressional objections to this strategy focused first on the purported lack of any substantial contribution by the exempt organization to the arrangement (other than its exemption) and second, on the risk that exempt

organizations would pay inflated prices, thus crowding out market competitors.<sup>21</sup> Finally, reiterating apprehensions similar to those expressed in the days of macaroni company ownership, Congress expressed concern about the growth potential afforded exempt organizations by these arrangements. Furthermore, Congress considered that if the sale-leaseback was on a nonrecourse basis, as was generally the case, there was virtually no financial risk to the exempt organization: if returns from the business were insufficient to support the payments due from the exempt organization, control would simply revert to the original owner-seller.

When this kind of nonrecourse sale-leaseback arrangement was tested before the Supreme Court in *Clay Brown*, the Commissioner of the Internal Revenue Service argued that without shifting the risks as well as benefits of ownership, there could be no real sale - "[s]ince the seller bears the risk, the so-called purchase price *must* be

---

21. See Weigel, *Unrelated Debt-Financed Income: A Retrospective (And a Modest Proposal)*, 50 *Tax Lawyer* 625, 641 (1997).

excessive and *must* be simply a device to collect future earnings at capital gains rates."<sup>22</sup> Nevertheless, the Court found that there was a valid sale despite the nonrecourse basis of the financing, and found sale treatment to be "fully consistent with the purposes of the Code to allow capital gains treatment for realization upon the enhanced value of a capital asset."<sup>23</sup>

In *Clay Brown*, the I.R.S. had attempted unsuccessfully to tax the seller's profits at ordinary rather than capital gains rates. However, when Congress wrote legislation to check the sale-leaseback strategy, it focused on the exempt organization-buyer rather than on the seller. Furthermore, Congress imposed the UBIT not only on income derived from property obtained wholly through nonrecourse debt, but on all otherwise exempt income to the extent derived from debt-financed property, and regardless of whether or not the debt was on a recourse basis. By the

---

22. *Clay B. Brown v. Commissioner*, 380 U.S. 563, 573 (1965).

23. *Id.*

time Congress came to debate what became the tax bill of 1969, this broader provision was justified precisely as a check on the ability of exempt organizations to enjoy "'growth which has no relation to public approval of the activities or purposes of the organization but rather arises from the organization's selling its exemption.'"<sup>24</sup>

#### Rudiments of UDFI in Practice

UDFI is imposed on all income of an exempt organization which would otherwise be nontaxable as passive unrelated income, to the extent such income is derived from investments acquired with borrowed funds. Expenses relating to such investments are allowed as deductions in the same proportion as the debt-financing bears to the total investment.

To determine the income subject to UDFI, the exempt organization must determine the annual "average acquisition indebtedness" (i.e., the average amount of debt

---

24. Joint Publication by the House Ways and Means Comm. and Senate Finance Comm., 91st Cong., 1st Sess., Tax Reform Studies and Proposals-U.S. Treasury Dept. 307, quoted in Weigel, *supra* note 21, at 646.



attributable to the property during the taxable year.)). The average adjusted tax basis of the property during the year is then computed. The debt-financed percentage for the year is the ratio of the average acquisition indebtedness for the year to the average adjusted basis for the year. It is that percentage of the income from the property that is treated as UDFI for the year.<sup>25</sup>

When the property is sold, the proportion of realized gain attributable to debt-financing will likewise constitute UDFI. To prevent avoidance of UDFI on income arising from sales by paying the debt at the end of one taxable year and selling the property immediately after the next taxable year begins, "average acquisition indebtedness" in the sale-of-property context is defined as "the highest amount of the acquisition indebtedness during the 12-month period ending with the date of the sale. . . ." <sup>26</sup> By the same token, if the debt has been repaid more than twelve

---

25. I.R.C. §§ 514(c)(7), 514(a)(1) and (2).

26. I.R.C. § 514(c)(7).

months prior to the sale, proceeds of the sale will not constitute UDFI.

As with UBIT generally, it is important to remember that debt-financed income will only be taxable if it is "unrelated" to the organization's exempt purpose. Income from property bearing acquisition indebtedness will not be taxed if "substantially all the use of . . . [the property] is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational or other purposes or function constituting the basis for its exception. . . ." <sup>27</sup> Note the parenthetical exclusion: it is not enough that the income be *used* to further exempt purposes. Rather, the business activity that generates income must bear a substantial relationship to the exempt purpose. For example, on the one hand, income from a debt-financed investment in a mutual fund, used to finance university construction, will be UDFI. On the other hand, if the university borrows directly to fund construction,

---

27. I.R.C. § 514(b)(1)(A)(i).

income from related use of the buildings will not be UDFI (though, as discussed below, certain investments might then be treated as debt-financed).

There are a number of statutory exceptions to the definition of debt-financed property. Several correspond to exceptions to the definition of "unrelated trade or business" contained in Section 513 of the Code. These exceptions cover property of businesses staffed by volunteers, businesses selling donated goods, and businesses which afford conveniences to the direct constituents ("members, students, patients, officers or employees") of the exempt organization.<sup>28</sup> Property used in certain research activities is likewise excepted, as is land near other property owned and used by the organization for exempt purposes and which is intended for future use for exempt purposes.<sup>29</sup>

"Acquisition indebtedness" is defined broadly to include not only debt directly attributable to acquisition

---

28. I.R.C. §§ 514(b)(1)(D), 513(a)(1)-(3).

29. I.R.C. §§ 514(b)(1)(c), 514(b)(3).

or improvement of a given property, but also indebtedness incurred before or after such transactions if it would not have been incurred "but for" the transaction.<sup>30</sup> Mortgages encumbering acquired property are likewise acquisition indebtedness.

Numerous and complex exclusions from the definition of "acquisition indebtedness" exist. Among these are obligations to pay annuities, housing construction financing insured by the FHA, indebtedness which is inherent to the exempt purposes, and securities lending. The I.R.S. has also ruled that short sales do not entail acquisition indebtedness.<sup>31</sup> On the other hand, a court has held that withdrawals of accumulated payments on life insurance policies do constitute acquisition indebtedness.<sup>32</sup>

Finally, certain types of exempt organizations, including employee benefit trusts and some educational institutions, benefit from a special exemption from taxes on

---

30. I.R.C. § 514(c) (1).

31. Rev. Rul. 95-8, 1995-1 C.B. 107.

32. Mose and Garrison Siskin Memorial Foundation, Inc., 86-1 USTC ¶ 9399 (6th Cir. 1986), 790 F2d. 480.

debt-financed real property. A number of technical requirements must be satisfied in order to qualify for the exemption. For example, the purchase price of the real property must be fixed and the terms of payment of the debt must be independent of revenue stemming from that property.<sup>33</sup> Moreover, when such organizations enter into real estate partnerships their exemption is subject to highly complex rules designed to prevent abuses in which tax-exempt partners could otherwise use their tax exemptions to benefit taxable partners in exchange for an increased tax-exempt return.

#### Policy Issues Raised by the UDFI Provisions

Should Debt-Financed Income Be Taxed as UBTI? If debt-financing is viewed as "bad," should it just be prohibited outright rather than taxing the resulting income as UBTI? Or should it be viewed as not "bad" enough to require some kind of special treatment? After all, the purpose of the UBIT is to prevent unfair competition in "business." Investment income (except for "debt-financed"

---

33. I.R.C. § 514(c)(9).

income) is protected from the UBIT because it isn't income from a "business." But debt-financed investment income also isn't income from a "business." Why should buying shares of IBM with borrowed money be viewed as more of a business activity than buying them with endowment funds? Perhaps, if the profits from the debt-financed IBM stock are channeled back into a "business" of the tax-exempt, they might be viewed as part of a business -- on a theory that flips the "destination of income" test to make exempt income taxable based on its destination; but suppose that the tax-exempt doesn't conduct any "business" and the net income from buying the leveraged IBM shares is spent promptly in performing exempt purposes? Should this "destination of income" matter in the context of debt-financed property? In short, if borrowing is a problem, is taxing the resulting income as UBTI a good solution?

As to how we got where we are on debt-financed income, I am informed by, and indebted to, Robert Reich's *Locked in the Cabinet*. The answer, of course, is politics. The UDFI provisions simply don't withstand careful analysis

in the "unfair competition in business" context in which they reside. But putting debt-financing in that context does have a surface appeal. That appeal derives from the idea that tax-exempts shouldn't be able to derive a tax-free return on the investment of funds that aren't theirs. The focus seems to be on unfairness (as distinguished from unfair competition in business), coupled with a vague fear of empire-building through leverage.

On a more visceral level -- probably the one that has mattered most, is the sense that leveraging has a go-go business feel. If so, even though the UBIT rules purport to deal with unfair competition as to "business" (not investments), why not treat leveraging similarly and tax the income it generates rather than prohibiting leveraging altogether? This is the choice Congress has made.

As to the tax-free treatment afforded to leveraged real estate owned by pension funds and schools (and their affiliates) where certain conditions are met, is real estate, after all, somehow different from other investments? It is almost always leveraged in the taxable world, and

pension funds are arguably different from other tax-exempts because their tax exemption is solely to permit tax deferral so that tax-free build-up of investment assets can occur; the payments to plan participants generally represent taxable pension income.<sup>34</sup> As for educational institutions, I'm stumped as to why they should be treated differently from other 501(c)(3) organizations; the only explanation seems to be that they enjoy political support that other 501(c)(3) organizations lack.

Another issue to consider is the relationship, if any, between debt-financing and risk. The cause of Congressional distaste with debt-financing is not easy to pinpoint -- as noted, it doesn't seem to be unfair competition in "business." If that distaste is tied to a concern about excessive risk-taking by non-profits, causing income from debt-financed investments to be taxable is only a partial remedy. It does put a cost on risk-taking through

---

34. Of course, payments by section 501(c)(3) organizations are often taxable income, such as salaries to employees performing exempt purposes, but the section 501(c)(3) tax exemption is not predicated upon simply deferring tax so as to permit tax-free investment asset build-up.



direct leveraging, but it ignores increased risk-taking from indirect leveraging. For example, purchases of puts, calls and futures involve a form of leverage in that the tax-exempt obtains an economic interest in the underlying asset without paying the full price of the asset. Yet puts, calls and futures purchased without borrowed funds don't give rise to "debt-financed" income because no "indebtedness" is incurred.<sup>35</sup> Also, a purchase by a tax-exempt of a third mortgage, without the use of borrowed funds, does not involve "debt-financing," but that investment does involve an indirect form of leverage because of the increased return for the third mortgage subordination. (Where an equity investment is made in a taxable corporation that has itself borrowed funds, the investment is leveraged but the corporation is taxable on the income from the leveraging.)

In view of the fact that a lot of economic leveraging is not covered by the debt-financing rules and that they do not deal with unfair competition in "business," one answer to the question of how leveraged investments

---

35. See General Counsel Memorandum 39,620 (April 3, 1987).

should be taxed is "Not at all," a proposal recently made by Weigel.<sup>36</sup>

One could argue that Congress and the I.R.S. have already accepted the wisdom of this proposal by not seeking to expand the definition of leverage beyond its current reach, i.e., the direct borrowing of funds for investment. As noted, by not seeking such expansion, they are permitting extensive leveraging to occur on a tax-free basis. The result may not be a bad one in balancing political and investment considerations. Permitting tax-exempts to use borrowed funds to make major acquisitions would likely raise a political outcry, but permitting quiet leverage through more esoteric means, such as those noted above, leaves investment managers for tax-exempts free to try to maximize returns on a tax-free basis through increasingly common investment techniques. Similarly, the exemption for leveraged real estate makes sense in terms of this political balancing act. While margin accounts remind people of the investment excesses of the '20s, leveraged real estate is at

---

36. See *supra* note 21.

the foundation of our economy -- witness the near impregnability of the home mortgage interest deduction. The detail that doesn't make sense in terms of this balancing act is that the provisions permitting leveraged real estate are limited to pension funds, schools and their affiliates. If real estate leveraging should be exempted (subject to various conditions) from the debt-financing rules for these institutions, it seems that all tax-exempts should enjoy a similar exemption.

Technical Concern About UDFI Provisions.

From a technical standpoint, section 514 also creates certain conceptual problems. The idea is to tax the net income from debt-financing, but the operation of the rules leaves something to be desired.

Interest Expenses. The most glaring error seems to be that interest expense is deductible just like other expenses (only in proportion to the debt-financing percentage), even though it is clearly attributable entirely

to the indebtedness.<sup>37</sup> Thus, if two investments, each costing \$100, are both 50% debt-financed, 50% of the interest expense will be deductible in computing UDFI. But if one of the investments is purchased entirely without borrowed funds and the other is purchased entirely with borrowed funds, all of the interest expense will be deductible in computing UDFI from the investment purchased with borrowed funds. The problem is that the statute and regulations do not distinguish between expenses directly related to the debt (e.g., interest) and expenses related to the debt-financed property, which should be deductible in proportion to the percentage of debt-financing.

Measuring Debt-Financing by Debt/Adjusted Basis Calculation. Another aspect of the technical working of the statute that produces odd results is the focus on adjusted tax basis as the denominator of the debt-financed fraction. Where a depreciable property has just been purchased, there is no problem. But if an unleveraged depreciable property has been owned for a long time, its tax basis will be low or

---

37. Treas. Regs. §§ 1.514(b)(1) and (2).

zero. (Depreciation "allowed or allowable" adjusts basis; accordingly, the fact that income from the property was tax-exempt in the past is irrelevant in determining basis at a given time.) Suppose the property is worth \$100 million, has a tax basis of zero and \$5 million of infrastructure improvements are made, using borrowed funds. It would appear that the property becomes 100% debt-financed (\$5 million of indebtedness and \$5 million of basis); on this analysis all of the income generated by the property is taxable, even though the debt-financing represents under 5% of the value of the property. Perhaps, however, the situation should be analyzed as one involving two properties: the old one worth \$100 million and the \$5 million of improvements. In that case, perhaps 100/105 of the rent should be treated as attributable to the non-debt-financed portion and 5/105 should be treated as 100 percent debt-financed. This result has real analytical appeal but it is not at all clear that a building can be viewed on having two separately rented components for purposes of the UDFI calculation, and I am not aware of any authority

directly supporting this view. Should it matter whether the renovations related to separately identifiable items like new elevators, as distinguished from renovation of the facade? One would think not, though the component theory certainly seems more plausible when applied to the elevators. If the debt-financing related to elevators, would it help to limit UDFI by having a tenant sign two leases, one for use of the space and one for use of the elevators. Clever, or too clever by half?

True Leverage as the UDFI Test. Despite this anomalous treatment of interest and "adjusted basis" under the statutory scheme, the I.R.S. has, on a technical level, been otherwise extremely classy in construing the statute in accordance with its intended purpose of taxing the use of leverage derived from the use of borrowed funds. It has declined to apply the statute literally where no economic leveraging exists. For example, where a tax-exempt lends money to its tax-exempt title-holding company, which uses the "borrowed" funds to acquire a property, the I.R.S. has found no debt-financing to exist, even though the property

was clearly acquired by the title-holding company with borrowed funds.<sup>38</sup> The I.R.S. has reasoned that, since the borrowed funds came from the parent, there was no effective leveraging because the parent and its title-holding company subsidiary were, together, simply investing their own funds. No borrowing from a third party had occurred. This is clearly the right conceptual result.

Treatment of Leveraging by Partnerships. One aspect of the economic leveraging analysis used by the I.R.S. that needs further amplification concerns leveraged partnerships. Revenue Ruling 76-95, 1976-1 C.B. 172, holds that a tax-exempt partner in a leveraged partnership does not hold debt-financed property through the partnership where the tax-exempt prepays its proportionate share of the partnership's mortgage indebtedness, receiving releases of liability, even though the entire property remains encumbered with the mortgage. There seems to be no authority, however, dealing directly with the situation in which a partnership borrows, and the tax-exempt partner does

---

38. Rev. Rul. 77-72, 1977-1, C.B. 157.

not prepay its share of the indebtedness, but all of the funds attributable to the tax-exempt partner's interest are supplied by the tax-exempt. This can occur, for example, where a partnership sells units of debt and equity in, say, a 2:1 ratio, and a tax-exempt investor purchases (with its own funds) two debt units and one equity unit. In this situation it seems to be clear, as a conceptual matter, that no leveraging of the investment of the tax-exempt investor is occurring: it is supplying all of the funds attributable to its investments in the partnership. Conversely, none of the borrowed money is producing a return for the tax-exempt investor. Accordingly, as leveraged investment partnerships of this type are increasingly common, it would be most helpful if the I.R.S. would issue a Revenue Ruling confirming the analysis above.

(Tax gurus will note the interaction between the above analysis and the non-recourse debt allocation rules under sections 752 and 704 of the Code. Those rules would ordinarily allocate a portion of any non-recourse financing to the tax-exempt investor for purposes of determining



deductions allocable to each partner; but, in the case of a tax-exempt that did not borrow to make its investment, such an allocation would be irrelevant and it should not, in my view, cause the no-leveraging analysis set forth above to be rejected.)

Borrowing of Property Other than Money. It is also relevant to note that the I.R.S. has effectively felt stymied by the technical wording of the debt-financed provisions in dealing with true leveraging that, however, involves the borrowing of "property" that is not money. Because the section 514 provisions tax income from incurring "indebtedness" and because the Supreme Court, in *Deputy v. DuPont*,<sup>39</sup> has construed "indebtedness" to mean the borrowing of money, the Service has concluded that section 514 does not apply to the borrowing of property. Accordingly, short sales of securities -- where securities are borrowed and sold, and the proceeds are invested -- do not give rise to

---

39. *Deputy v. DuPont*, 308 U.S. 488 (1940).

debt-financed income under a 1995 I.R.S. Ruling.<sup>40</sup> While those of you with total recall will remember that I anticipated this result in a prior paper to this group discussing the "prudence" of short selling, I find the result to be strange as a conceptual matter, however correct it may be (and it is) as a technical matter of statutory construction.

My own test for leverage is simple: Does the tax-exempt have working for it any funds that are not its own?<sup>41</sup> In the short-selling context, the borrowed asset is sold for proceeds that are invested for the benefit of the tax-exempt (though it may share the return with the broker); in addition, the short sale itself involves a form of "investing for depreciation," i.e., the tax-exempt makes a profit on the security sold short if it depreciates. Accordingly, short selling can be viewed as the making of two investments without direct use of an organization's

---

40. Rev. Rul. 95-8, 1995-1 C.B. 107.

41. This test does not, of course, deal with indirect leverage, such as that involved in acquiring puts, calls and futures.

funds. Yet under existing law, no part of any net return is subject to taxation as UDFI.

Tracing Borrowed Funds, Used for "Related"

Activities, to Investments. Another technical matter of interest to the practitioner is the tracing of debt-financing to a particular investment. On the one hand, the debt-financing provisions are quite mechanical and reasonably clear in specifying how to identify a property as debt-financed: in general, the borrowed funds are traced to the investment property acquired by using those funds; on the other hand, the "but for" concept creates some vagueness where large portfolios are involved. Also, the concept of "related" indebtedness as not giving rise to UDFI is subject to the "but for" caveat. Treasury Regulations Section 1.514(c)-2 (Example 2) provides that when working capital is used to make an investment at a time when it is foreseeable that the funds will be needed for "related" activities, the investment is deemed to be debt-financed because the need to borrow to pay for the expenses of the

related activities would not have occurred "but for" the use of the working capital to make an investment.<sup>42</sup>

Notwithstanding the logic of this regulation, I am unaware of any instance in which it has been applied. Yet one would think that it would have broad application to universities that often borrow, say, for dormitory construction, when they are also engaged in running large investment portfolios. While the borrowing to finance construction of the dormitories is "related," it would have been unnecessary if available endowment funds had been used to pay for the construction. Thus, it seems that, in practice, tracing of borrowings tends to be straightforward: What was bought with the borrowed funds? If what was bought was not an investment, then no UDFI seems to arise as a practical matter. Perhaps, however, I am unaware of instances where the regulation has been applied in a non-ruling, non-case context. It does exist, and I always advise clients of that fact. Perhaps in what I expect to be the most common circumstance -- the construction of

---

42. See also Treas. Regs. § 1.514(c)-2 (Ex. 3).

dormitories -- the policy of encouraging such construction (New York State has its own "Dormitory Authority") has prompted an I.R.S. policy of not attacking the use of the borrowed funds.

Tracing Borrowed Funds, Used to Acquire One Investment, to Another Investment. Another aspect of tracing worth noting is the flexibility the tracing rules apparently give in permitting tax-exempts to choose debt-financing for certain investments and not others. While the Treasury Regulations cited above permit the reallocation to investments of borrowed funds actually used for non-investment purposes, there seems to be no authority for reallocating to an investment debt-financing used to acquire another investment.

Accordingly, tax-exempts with substantial portfolios that wish to invest borrowed funds can seek to do so in a way that minimizes UDFI. For example, a tax-exempt that invests a portion of its endowment in venture capital stocks -- normally a fairly long-term, non-dividend paying investment -- might seek to use borrowed funds to make such

investments, with a view toward paying off the borrowing more than 12 months before the investments are sold. If that occurs and no dividends are paid, the investments will not generate any UDFI, despite having been debt-financed for several years, or more.

Moreover, as noted above, investing borrowed funds so as to maximize the debt-financed percentage for a particular investment will cause more of the interest expense to be deductible in computing taxable UDFI than would occur if several investments were only slightly debt-financed (e.g., having 5 investments each costing \$100 be 20% debt-financed (\$100 of borrowing) will cause 20% of the interest expense to be deductible, but having one be 100% debt-financed and the others be 0% debt-financed will result in 100% deductibility of the interest expense).

While one could wonder about the wisdom of direct tracing to particular investments, this tracing method produces a level of certainty and (relative) administrative simplicity that would be absent from alternative tracing rules. For example, deeming leveraging to apply pro rata to

all investments in a portfolio, or all investments acquired in the taxable year in which the borrowing occurred, would involve extensive and costly bookkeeping, particularly where a big portfolio was involved. Such treatment would also dramatically reduce the deductibility of the interest expense because each of a much larger universe of investments would be only slightly debt-financed.

### Conclusions

In view of the fuzzy conceptual foundation on which the debt-financing rules rest, and in view of the fact that they reach only the most direct forms of leveraging (the use of borrowed money), there is a case to be made, as Weigel has demonstrated, for scrapping them altogether. However, they may embody, as noted, a sort of political midpoint between taxing the kind of direct leverage, highly visible economic empire-building that seemed to concern their creators and allowing, without taxation, the use of now-common, yet somewhat esoteric investment techniques used by money managers to enhance and protect portfolio returns.

Similarly, from a practical perspective, while imposing taxation on UDFI under the UBIT rules doesn't make sense in terms of the stated purpose of those rules -- taxing unfair competition in business -- that treatment is plausible in the absence of a special regime to tax income from leveraged investments. Such a regime would involve complexity and that, coupled with its inherent novelty as a new tax, would impose substantial additional compliance costs on tax-exempts. Accordingly, I certainly do not think that a new tax of that kind is desirable.

Finally, the UDFI statutory and regulatory provisions have not received a lot of attention, and so they offer anomalies, a few of which I have noted. (The REIT provisions on qualifying income, by contrast, offer an example of how much clarifying and cleaning up can go on when an industry group is deeply affected and politically effective.) Some I.R.S. attention to the UDFI anomalies would be welcome, particularly in light of the I.R.S.'s excellent history of interpreting the UDFI rules so as to



carry out their purpose, and of avoiding overly literal,  
nonsensical interpretations.