The ABCs Of UBTI:

A Practical Guide To Avoiding Unrelated Business Taxable Income From Real Estate Investments

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When nonprofits make profits, what are the rules?

A COMMON PERCEPTION OF FEDERAL TAX LAW is that it is characterized by a confusing set of exceptions and exceptions to exceptions and exceptions to those exceptions. This view is justified with respect to the federal tax law governing investments by tax-exempt organizations ("TEOs"). This article will guide the practitioner through the maze of rules that apply to TEOs by examining choices of strategies for TEOs in some common fact patterns. Being familiar with these rules will aid not just the practitioner representing the TEO but also the practitioner negotiating with the TEO in bringing a deal to a successful conclusion. Focusing on three types of common real estate deals—(1) a hotel with various amenities, (2) an office park, and (3) a residential development with a period of rental followed by sales of con-

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dominium units—this article will review the issues and investment vehicles practitioners should consider.

Throughout this article "TEOs" will refer to qualified pension trusts exempt from taxation by virtue of section 401 of the Internal Revenue Code, or to nonprofit organizations, including charitable and educational organizations (collectively "charitable organizations"), exempt under section 501. (All section references are to the Code unless otherwise indicated.)

INTRODUCTION TO UBTI • Under the Code, the unrelated business income tax ("UBIT") imposes the section 11 corporate tax rates on the unrelated business taxable income ("UBTI") of TEOs. Short of outright disqualification as a TEO, imposition of the UBIT is the most important financial consequence a TEO can experience, resulting in the difference between a tax rate of zero percent and one of 35 percent.

Before 1950, the determination of the existence of a valid TEO, mainly for purposes of the predecessor to section 501, was based on a "destination-of-income" test: an organization that dedicated its income to charitable purposes could claim to be a tax-exempt charitable organization. In the most famous case, *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951), a promoter hatched a scheme in which C.F. Mueller Co., a New Jersey corporation that manufactured macaroni, was taken over by C.F. Mueller Co., a Delaware corporation, using borrowed funds. The Delaware corporation stated in its certificate of incorporation that it had been organized for charitable and educational purposes and that all funds after payment of indebtedness from the leveraged purchase were dedicated to the New York University School of Law. The Third Circuit held that such an arrangement was within the language of section 101(6) of the Internal Revenue Code of 1939 (exempting charitable organizations from taxation) because all of the Delaware corporation's profits were to be paid over to a charitable organization, regardless of how those profits were procured, and therefore the Delaware Corporation was tax-exempt. 190 F.2d at 122. This gave C.F. Mueller Co. and other such corporations a business advantage over their taxable competitors, including the ability to sell products at a lower price.

Responding to the complaints of competing businesses, in 1950 Congress enacted the first UBTI rules and made such "feeder organizations" subject to regular corporate tax. As stated in the Senate Reports:

"The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section 101 organizations enables them to use their profits tax-free to expand their operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemptions to buy an ordinary business. That is, they have acquired the business with little or no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable."

1950 U.S.C.C.A.N. 3053, 3081. However, Congress did not disturb the tax exemption for dividends, interest, most rents, and capital gains under the theory that (1) such income is unlikely to result in unfair competition; and (2) historically, passive income was viewed as a proper investment for TEOs. *Id.*

Thus Congress imposed this tax on (1) income from unrelated business operations; and (2) from rentals of property purchased with borrowed funds and leased for five years or more. *Id.*, at 3078. In doing so, Congress addressed two emerging abuses: unfair competition and

the use of debt-financing. In addition to cases like *C.F. Mueller Co.*, Congress had become concerned about lease-back transactions in which a TEO would purchase an asset, often a retail store property, with borrowed funds and pay the purchase price using rental income over many years. *Id.* at 3084. Congress objected on the grounds that:

- The TEO contributed only its own exemption and no funds of its own;
- Unchecked, it could lead to the concentration of real-estate ownership in the hands of TEOs; and
- By higher purchase prices or lower rental prices, the TEO essentially had sold part of its exemption. *Id.*

Room To Maneuver Remained

Yet these two rules also created opportunities for exploitation of the tax-exempt status of nonprofit organizations by clever planners. From these rules emerged a practice of purchasing businesses with debt in what were called "*Clay Brown*" transactions after the Supreme Court case of the same name. A business corporation would be purchased by a nonprofit organization using an installment note payable from earnings of the corporation's assets over less than five years. The business corporation would then be liquidated—tax-free—into the nonprofit organization parent under the pre-1986 liberal liquidation rules of *General Utilities*, and the assets would be leased back to the sellers who had since organized an operating corporation. Thus, the nonprofit organization would receive a portion of tax-free rents from a transaction in which it had no investment and the shareholders of the subject corporation had ordinary gain converted into capital gains by then receiving essentially income produced by the operating assets as payment of the stock purchase price. *Commissioner v. Brown*, 380 U.S. 563, 573 (1965).

Congress sought to end this game by enacting the unrelated debt-financed income provisions of section 514, pursuant to which income from property is UBTI to the extent that the investment in such property was financed with debt. This could apply (1) when the purchase was financed with debt, or (2) when debt was subsequently placed on the property, and the incurring of debt was reasonably foreseeable at the time of acquisition. The primary exceptions, then, were for exempt-function income, i.e., income directly related to the nonprofit organization's tax-exempt purpose, and when income had already been taxed as UBTI.

Pension Trusts Get A Break

In 1980, Congress carved out an exception to the UBTI rules for qualified pension trusts investing in real estate. S. Rep. No. 96-1036, at 29 (1980). This was in some ways related to the exception for exempt-function income in that its purpose was to "enable them to accumulate funds to satisfy their exempt purpose—the payment of employee benefits." This exception came at a time of runaway inflation in which real estate was believed to be the safest hedge against inflation. But this exception would apply only when the purchase price was a fixed amount. Further expansion of the exception came in 1984 when nonprofit educational organizations defined under section 170(b)(1)(A)(ii) and certain nonprofit title-holding entities also became qualified organizations subject to the exception from unrelated debt-financed income rules. The new legislation also provided that the exceptions to unrelated debt-financed UBTI would also apply to interests in partnerships only if all partners were eligible for the exemption or there were a qualified allocation, discussed below. H. Rep. No. 98-861, at 1096-98 (1984).

These provisions were further amended in 1988 with creation of the "fractions rule" (fur-

ther discussed below) pursuant to which the exception from the unrelated debt-financed income prohibition also applied to partnership investments in real property if:

- The allocations complied with the section 704 requirement of substantial economic effect and the regulations thereunder; and
- Subject to exceptions, no partner that was a qualified organization (defined below) could receive an allocation of a share of income for any taxable year greater than such qualified organization's smallest share of losses for any taxable year.

The purpose of this 1988 amendment was to prevent shifting of tax benefits from TEOs to taxable persons in partnerships by means of assigning taxable income to a TEO and losses to taxable entities.

KNOW YOUR CLIENT/KNOW THE DEAL • Before analyzing the applicable law regarding TEOs, the practitioner must be comfortable regarding all aspects of the transaction. First, it is important to understand the client and its organizational purposes. At the beginning of this article, three examples of deals were given: a hotel, an office, and a residential development that would be converted to condominium units. The attributes of the client will sometimes determine which type of investment is optimal and the procedures for effecting such investment. If the client is a TEO exempt under section 501(c)(3), for example, there may be an applicable tax-exempt purpose that can be used for broad protection from attribution of UBTI. Hospitals, universities, and urban redevelopment organizations warrant particular attention with respect to broad application of exempt purpose to real estate investments, as will be discussed below. On the other hand, such nonprofit organizations must be careful about the size and extent of profit-generating activities, lest they be found to have abandoned their original tax-exempt purpose and risk disqualification as a tax-exempt nonprofit organization. *See* Treas. Reg. §1.501(c)(3)-1(c)(1) (describing the operational test). However, a qualified pension trust, because it lacks a tax-exempt purpose, cannot rely on any tax-exempt purpose to avoid UBTI, but it also need not be concerned about the size of its investments compared to its overall activity.

Second, it is important to understand the deal. In addition to understanding the broad outlines of the deal, it is important to know what services and amenities will be provided to those using the real estate, and by whom. Depending on the deal and the choice of investment vehicle, a TEO may find that some percentage of its investment, or even all of its investment, is subject to UBIT on some level of the deal. Practitioners who represent clients on such transactions should have developed a standard questionnaire designed to flesh out these issues. It is the responsibility of the practitioner to sensitize the client to the importance of fully responding to the questionnaires. But even having done so, the client may still incompletely or inaccurately answer such questions, doing so at its own risk. Depending on which persons have common control of different parties to the same transaction, there are UBIT risks ranging from attribution of taxable activities to a TEO to outright disqualification of a nonprofit organization's tax-exempt status. Thus, part of the due diligence involves understanding the organization of all parties to the transaction, including lessees and various service providers.

CHOICE OF INVESTMENT VEHICLE • Perhaps the most important recommendation the practitioner can offer with respect to real estate investments is which investment vehicle to use. In examining investment vehicles, this article will compare direct investing with

use of partnerships, REITs, C corporations, and S corporations.

Direct Investing

As discussed above, exempt-function income will not be UBTI and will thus be exempt from taxation. Treas. Reg. §1.513-1(d). The conduct of such trade or business must have a "causal relationship" to the nonprofit organization's exempt purposes and such causal relationship must be substantial, and the size and extent of such income-generating activities must be necessary with respect to the exempt function purportedly served. Treas. Reg. §1.513-1(d)(2), (3). The Treasury Regulations promulgated under section 513 give several examples of exempt-function income, including proceeds of performances by students at a school for the performing arts and proceeds of sales of advertising time on a radio station run for the advancement of public interest in classical music. Treas. Reg. §1.513-1(d)(4)(i) (Ex. 1), (d)(iv)(Ex. 4).

As a general rule, if a TEO's income is not exempt-function income, it may be UBTI under section 511. Section 512(b) modifies this result to exclude passive income such as dividends, interest, payments on securities loans, royalties, real property rents (except when more than 50 percent of the proceeds is attributable to personal property or when rent is determined with respect to lessee net income or profits) and capital gains. UBTI will include payments from 50-percent controlled entities when such payments reduce the taxable income of the controlled entity and will also include income from sales of inventory or property held primarily for sale to customers in the ordinary course of business. §512(b)(13)(D). (Fifty-percent controlled entities are organizations more than 50 percent of which are owned by the TEO, including by reason of the constructive ownership rules of section 318). This passive income exception to UBTI is itself subject to the exception for unrelated debt-financed income. §512(b)(4).

Under section 514(a), the unrelated debt-financed UBTI included is based on the ratio of average acquisition indebtedness over the taxable year to the average adjusted basis over the taxable year. Under section 514(c), acquisition indebtedness is the unpaid amount of indebtedness used to acquire or improve property, or incurred before or after acquisition or improvement if the debt would not have been incurred but for acquisition or improvement and, if incurred after, was reasonably foreseeable at the time of acquisition or improvement. Under section 514(b)(1)(A)(i), debt-financed property does not include property for which substantially all the use is substantially related to the TEO's tax-exempt purpose.

Generally, acquisition indebtedness does not include indebtedness incurred by qualified organizations to acquire or improve real property. §514(c)(9)(A). Qualified organizations are listed under section 514(c)(9)(C) as nonprofit educational organizations under section 170(b)(1)(A)-(ii) and their affiliated support organizations, section 401 qualified pension trusts, and section 501(c)(25) nonprofit title-holding organizations. The exceptions do not apply when:

- The price of acquisition or improvement is not fixed as of the date of the acquisition or improvement;
- Indebtedness is determined with respect to profits from the subject real property;
- The real property is leased back to the seller or to a person related thereto under sections 267(b) or 707(b);
- The real property is acquired by a qualified trust from, or leased to, persons described in certain prohibited relationships under the ERISA provisions at section 4975(e)(2) (This is designed to prevent acquisition of real property by qualified pension plans at bargain prices on

the theory it could result in excess contributions to plans by the employer for the benefit of highly compensated individuals and other favored persons. Pvt. Letter Rul. 200318076, citing S. Rep. No. 96-4036 (1980));

- Persons with the relationships listed in the preceding two bullets provide the financing for acquisition or improvement; or
- The real property is held by a partnership (subject to the discussion in the partnership section of this article). §514(c)(9)(B).

Hotels

With respect to the three deals this article contemplates, hotels have the most riding on exempt purpose, for if the exempt-function income exclusion is not available, then there are no passive exceptions (other than net leasing) for hotel income and all income from direct ownership and operation of a hotel will be UBTI. Hotels, because of their inherently active nature, have garnered special scrutiny from the Internal Revenue Service. Thus, those contemplating direct investment in a hotel must navigate a mine-field of issues and history that the practitioner may seek to avoid by structuring the investment as a lease of a building to a hotel operator or a loan of funds to the developer. *See* Pvt. Letter Rul. 8301110 (Service states that interest from a loan provided to an unrelated partnership to construct and operate a hotel in a depressed urban area will not be UBTI).

General Counsel Memorandum 38060 stated the principle that a hotel may not be a related trade or business except when the area served is "comparatively isolated and lacking in…lodging facilities." This rule combined the legislative history from the 1950 and 1969 legislation: First, in the 1950 Congressional hearings that led to the first set of UBTI rules, representatives of certain colleges asserted that without hotels, it would be impossible for them to operate. Moreover, the 1969 legislative history, noting Congressional expansion of UBIT coverage, stated: "Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not taxing a country club or a lodge engaged in a similar activity." Joint Committee on Internal Revenue Taxation, *General Explanation of the Tax Reform Act of 1969*, 91st Cong., 2d Sess. at 66-67 (1970) (cited in GCM 38060). GCM 38060 further stated, "These statements from both the 1950 and 1969 legislative history indicate, we believe, that absent special circumstances, *e.g.* geographical isolation, Congress considered the operation of a public hotel or restaurant by a tax-exempt college a taxable business activity."

Thus, when a hospital operated a hotel and was not able to show special circumstances, the Service ruled that income from operating a hotel would be UBTI. Pvt. Letter Rul. 8031075. A museum located in an area remote from other lodging facilities also was refused a positive ruling on exclusion of hotel income from UBTI because it could not show that visitors would devote greater time to the education endeavors as a result of lodging at the hotel. Pvt. Letter Rul. 8949093. However, in Pvt. Letter Rul. 9404029, the Service did grant a ruling regarding income from a hotel run by a hospital, but not to the extent that revenue came from the general public instead of from patients and their families. Then, in Pvt. Letter Rul. 9551037, the Service liberalized its position somewhat. There, the nonprofit organization was to build an aquarium, research facilities, and a hotel in an area designated as economically depressed. There were no other hotels close enough to facilitate visiting the aquarium and other related developments. However, it should be noted that upon construction of the hotel, title thereto would be transferred to a municipality. Thus, municipal control may also be a significant element in exempting hotel proceeds from UBTI. There is, however, some consolation for the TEO that has

been incurring UBIT from hotel income regarding disposition of such business assets. If a TEO has been accruing UBTI as a result of its ownership and operation of an active hotel business, at least the sale of the hotel will qualify for the passive income exception for capital gains on sales under section 512(b)(5), assuming that the hotel was not debt-financed.

Office Buildings

An office, by contrast to hotels, presents two opportunities for income free from UBTI: for nonprofit organizations that can make use of their tax-exempt purpose and for the passive income exclusion of rental of real property for all TEOs. The tax-exempt purpose authority for office developments is relatively more established. Combating community deterioration was recognized as a proper charitable purpose in Rev. Rul. 68-15, 1968-1 C.B. 244. The Service further declared that providing debt or equity financing to businesses located in distressed areas was a proper tax-exempt purpose in Rev. Rul. 74-587, 1974-2 C.B. 162. The Service expanded this recognition to an organization purchasing "blighted land" and converting it into an industrial park, and leasing space to businesses. Rev. Rul. 76-419, 1976-2 C.B. 146 (However, lots were leased on terms "sufficiently favorable to attract tenants to this economically depressed area.") The Service also recognized the debt participation of a tax-exempt nonprofit organization in funding low-income housing, office construction, and parking lots as being in furtherance of its urban redevelopment purpose. *See* Pvt. Letter Rul. 8923070 (the Service found the nonprofit organization's investment in an office building to be "program-related," a concept that is related to the UBTI issue in the context of private foundations).

When tax-exempt purpose is inapplicable or when it is unavailable as is the case with qualified pension trusts, the TEO must rely on the passive income exclusion, such as from rent under section 512(b)(3)(A) and take greater care regarding the nature of its activities, using the questionnaires referenced above. Provision of too many services to the customer will disqualify rental income from being considered passive. Treas. Reg. §1.512(b)-1(c)(5) states that "pay ments for the use…of rooms or other quarters in hotels…or for the use of occupancy of space in parking lots…does not constitute rent from real property." This Treasury Regulation also states that such income will not fail the rental exclusion of the services in question if "usually or customarily rendered in connection with the rental of rooms or other space for occupancy only" and listed as an example of permissible services "furnishing heat and light and cleaning of common spaces." Furthermore, it is irrelevant whether the TEO performs the services directly or through an independent contractor; if prohibited services are provided, the rental income may fail the passive income exclusion. *See* Rev. Rul. 2004-24, 2004-10 I.R.B. 550. This should be distinguished from a situation in which the TEO net leases property, such as a parking lot, to an unrelated operator. Pvt. Letter Rul. 200241050; GCM 39825. This also suggests for the alert practitioner advising a nonprofit organization that when the investment is in a distressed area, exempt-function income may be the best bet for avoiding UBTI; but when the investment is located in an affluent area, the practitioner may wish to use the passive income exception and note what services are considered customarily rendered in such area.

Residential Housing

As with rental of office buildings, rental of residential housing can generate exempt-function income provided that the proper tax-exempt purpose is available. For instance, providing rental housing to the elderly has long been

recognized as a valid tax-exempt purpose. Rev. Rul. 79-18, 1979-1 C.B. 194; Rev. Rul. 72-124, 1972-1 C.B. 145; Pvt. Letter Rul. 9001036. Likewise, sales of low-income housing units in a condominium sale by a charitable organization will also not generate UBTI, even when the disposition of such condominium units is anticipated to be for fair market value, but care must be taken to ensure that the price is still "within the reach of a significant segment of the community" and, therefore, such charitable class is still served. Rev. Rul. 70-585, 1970-2 C.B. 115; Rev. Rul. 67-138, 1967-1 C.B. 129; Pvt. Letter Rul. 9311034; Pvt. Letter Rul. 9540067 (condominium units sold to elderly residents thereof). However, exiting the investment under such circumstances may also require representations by the nonprofit organization that the profit from such sales will be minimal. Pvt. Letter Rul. 200211052.

Also, similar to the rules regarding the rental of office buildings, rental income from residences may be received free of UBTI based on the passive income exception, subject to section 514, provided that impermissible services are not provided (which again may differ depending on the neighborhood of the investment). However, unlike the case of office buildings, there is a risk that the quantity of condominium units sold will render the TEO a dealer of real estate, thus failing the capital gains exception under section 512(b)(5), unless the TEO sells the units as a block.

Partnerships

Partnerships will often be a preferred investing vehicle. Often the TEO will not have the requisite expertise or money to bring a real estate project to fruition by itself. A partnership (or a limited liability company treated as a partnership) will allow money and expertise to come together in a vehicle that is exempt from taxation at the entity (partnership) level and taxable only at the partner level. However, partnerships have often proved useful for those looking to transfer desirable tax attributes. Therefore, in response to perceived abuses, complex rules have evolved to govern partnerships in which TEOs participate. This discussion will cover partnerships where a nonprofit organization seeks to make use of its tax-exempt purpose and those in which the TEO is relying on the passive income exclusion.

In the case of TEO investments that rely on tax-exempt purpose for exemption from UBTI, this area of the law imposes penalties ranging from UBTI to outright disqualification of the nonprofit organization's tax-exempt status. Under Rev. Rul. 98-15, the activities of a partnership, including a limited liability company, are attributed to the tax-exempt partner. A TEO that is a nonprofit organization may form and participate in a partnership as a general partner or, in a limited liability company, as a managing member, only when doing so advances its tax-exempt purpose and when the partnership agreement "permits the charitable organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of for-profit investors." Rev. Rul 98-15, 1998-1 C.B. 718; *see also* Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, at §32.2(b) (John Wiley, 8th ed. 2003). If the partnership does advance a tax-exempt purpose, the nonprofit organization can still risk revocation of tax-exempt status if the nonprofit organization is responsible for the day-to-day responsibilities of the partnership or if the taxable partners receive undue economic benefits. Hopkins, at §32.2(a). The key to this analysis is whether the nonprofit organization's participation provides private benefit to for-profit parties that is qualitatively and quantitatively incidental. Pvt. Letter Ruls. 9637050, 8541108; Hopkins, at §32.2(b). (Viewing the issue through this lens may resolve the analytic tension between insulating the nonprofit orga-

nization and maintaining enough control to ensure that the partnership serves exempt purposes.) Although some partnerships have been approved as having the requisite furtherance of exempt purpose over private benefit, often the for-profit partner will balk at the degree of control that must be relinquished, making use of the partnership structure not viable. Some of these concerns may still be present even when the nonprofit organization participates as a limited partner or non-managing member, although the smaller the participation relative to the size of the nonprofit organization, the less concern there is over maintaining tax-exempt status.

Even if the nonprofit organization clears the hurdle of tax-exempt purpose and disqualification of tax-exempt status is not at issue, the practitioner must still be concerned about UBTI attribution by means of section 512(c)(1). Section 512(c)(1) provides that if a partnership carries on activities that would be an unrelated trade or business if carried on directly by the TEO, the TEO must take into account its allocable share of taxable income. Rev. Rul. 79-222, 1979-2 C.B. 236, provides that the rule of section 512(c)(1) applies whether or not the TEO is a general or limited partner. Yet the classification of income as UBTI may still depend on who controls the partnership and to what end. In Pvt. Letter Rul. 8923001, the Service determined that a section 501(c)(4) community development nonprofit organization that had invested in a partnership that operated hotels as part of nationwide for-profit operations could not rely on its tax-exempt purpose to exempt income from UBTI. This was true even when the hotel in question was located in a convention center whose development was pursuant to the nonprofit organization's tax-exempt purpose and when 70 percent of projected hotel guests would attend convention center functions, although the size of the investment was determined not to endanger the nonprofit organization's tax-exempt status. Pvt. Letter Rul. 8923001 Thus, for most nonprofit organizations, relying on the partnership operating in a manner consistent with such nonprofit organization's tax-exempt purpose to avoid incurring UBIT will carry significant risks.

Passive Income Exception

With reliance on tax-exempt purpose perhaps too risky for nonprofit organizations, all TEO investors must rely on the passive income exception from UBIT, and therefore must be particularly careful regarding unrelated debt-financed income and passive income. With respect to unrelated debt-financed income, as discussed above, debt-financing via partnership investments in real estate will result in acquisition indebtedness and thus in UBTI unless all partners are qualified organizations, all allocations are completely level at all times throughout the existence of the partnership (a qualified allocation under section 168(h)(6)), or the partnership satisfies the fractions rule. Under the fractions rule, a qualified organization that is a partner may not be allocated at any time a share of income greater than its smallest share of losses. §514(c)(9)(E)(i). As noted above, the partnership allocations must also satisfy the substantial economic effect rule, which means that they must be section 704(b) compliant. §514(c)(9)(E)-(ii). These rules must be satisfied on a current and a prospective basis. Treas. Reg. §1.514(c)-2-(b)(2)(i). However, a subsequent change, if unanticipated, that causes a fractions rule violation causes it only for that year and forward. Treas. Reg. §1.514(c)-2(b)(2)(ii).

This might seem to restrict unduly many varieties of business deals. Fortunately, there are several important exceptions that reflect certain business realities. Guaranteed payments are excluded from this rule if a reasonable amount for capital or services. Treas. Reg. §1.514(c)-2(d)(3).

Also excluded are reasonable preferred returns on capital which may be calculated on a current or a cumulative basis. Treas. Reg. §1.514(c)-2(d)(2). A safe harbor is provided for preferred returns of either applicable federal rate plus four percentage points or 150 percent of applicable federal rate, but in today's interest rate environment, such rate of return is considered meager at best. Treas. Reg. §1.514(c)-2(d)(4)(ii). However, a preferred return still complies even if greater than the aforementioned safe harbor if such preferred return is commercially reasonable. *Id.* Today, preferred returns of 15 to 20 percent are not uncommon.

Returning capital contributions to contributing investors, which is not an income-recognition event, is also excluded from fractions rule computations. Treas. Reg. §1.514(c)-2(d)(5). Chargebacks are also excluded, even if disproportionate, if reversing disproportionately high allocations of loss or small allocations of income, as long as made in the same ratio and order of the allocations being reversed. Treas. Reg. §1.514(c)-2(e). Regulatory chargebacks and other operations such as qualified income offsets and revaluations of property for capital account purposes will also be excluded from the coverage of the fractions rule. Pvt. Letter Rul. 9128020. Changes in the partners' interests in the partnership may also result in permitted changes in allocations when they reflect genuine economic shifts. Treas. Reg. §1.514(c)-2(k)(1). Such shifts may even occur as part of sanctions imposed by the partnerships on partners who fail to meet a capital call. Pvt. Letter Rul. 200351032.

Special care must be taken with use of tiered partnerships. To satisfy the fractions rule, use of tiered structures must not have tax avoidance as a principal purpose and the chains of ownership must satisfy the requirements of Treas. Reg. §1.514(c)-2(b)(2) through (k). Treas. Reg. §1.514-(c)-2(m).

Capital Contributions, Waterfall, And Tax Allocations

A partnership agreement typically has three sets of provisions of most immediate concern to the practitioner: the capital contributions, the waterfall (cash distributions), and the tax allocations section. (Emphasis on these provisions should not be interpreted as relieving the tax practitioner's responsibility to review the entire agreement.) As a business matter, often the TEO (especially one looking for a return on investments instead of achievement of a particular project for a particular tax-exempt purpose) provides the money and a developer provides the expertise in exchange for a deferred incentive. Thus, frequently, the TEO will want its money out first, but the taxable partner will want the profit potential (the "promote" or the "back-end"), which gives the developer an incentive to see the development through. The fractions rule can accommodate this kind of business deal, allowing for a typical structure that looks something like this:

- Payment of a high preferred return to partners making extra capital contributions at crucial business moments;
- Return of the extra capital contributions to such contributors;
- Payment of a lower preferred return on the original contributions;
- Return of the original capital contributions; and
- Some division of remaining cash, usually favorable to the taxable partner supplying expertise, often with the promote increasing as certain cash targets are met. *See, e.g.* Pvt. Letter Rul. 200224014.

The sequence of cash distributions (the "waterfall") generally will be reflected in the tax allocations of income and loss. Because the goal of taxable partners is to have the tax allocations reflect the economics of the waterfall by, among

other things, minimizing phantom income (income in excess of cash distributions), the intersection of the pressures of the waterfall and the issues on allocation create the greatest fractions rule risks. Again, because the fractions rule tests the highest share of income against the lowest share of losses, and because a TEO is permitted a decreasing share of income, these parameters can fit most deals where the taxable partner receives the promote. However, significant creative restructuring is required when the goal is to provide the promote to the TEO.

Often the waterfall will be reflected in the allocations in two ways, either by income-tracking allocations or by building and unbuilding capital accounts. The income-tracking method usually allocates income to the TEO and taxable partners by allocating according to preferred returns, ignoring returns of capital, and then allocating income according to the percentages set forth in the promote phases. Loss allocations can then be set at a level equal to or greater than the TEO's highest share of income. This creates several problems that must and can be managed by the careful practitioner. The first is that economic events that generate phantom income must be carefully managed, especially in light of the existence of corresponding tiers of waterfall distributions that did not generate income charges. The second is that these anomalies (including phantom income) may cause capital accounts to rise and fall and thus affect the payments upon liquidation of the partnership made pursuant to positive capital accounts. If the parties attempt to remedy undesired capital account levels with a "gain-force" allocation of income, care must be taken to ensure that such allocation will not violate the fractions rule or section 704(b).

Some practitioners try to avoid these problems by use of capital account building and unbuilding allocations. The goal with these allocations is to create income and loss charges designed to target certain capital accounts so that liquidation would result in certain desired distributions to the partners. The drawback is that this may involve sufficient complexity at the accounting level and require sufficiently reliable projections that the practitioner may not be able to rely on the ability of the parties to faithfully carry out the intended transaction.

In any event, the good news is that the TEO in a partnership that has complied with the fractions rule, will be able to exit the deal free of UBTI. The TEO that has complied with the fractions rule is deemed not to have acquisition indebtedness and thus can sell its interest pursuant to section 512(b)(5) without application of section 514. (On the other hand, the TEO that has not attempted to comply with the fractions rule must still be concerned about debt-financed income. TAM 9651001.)

Passive Investing In Offices and Hotels

With respect to passive investing in an office development, fractions rule compliance can keep the TEO free of UBTI from section 514 from acquisition of the partnership investment to liquidation. For a hotel development, hotel activity is just too active to qualify for the passive income exception; therefore, fractions rule compliance cannot save operating income from the taint of UBTI. However, because income from the sale of the TEO's interest in the hotel business can still be free of UBIT, fractions rule compliance to avoid application of section 514 is still crucial for reliance on section 512(b)(5). For a TEO investing in a residential development to be sold as condominium units, fractions rule compliance can protect rental income from the section 514 taint before units are sold. Once condominium units are sold in quantity, the dealer exception to the section 512(b)(5) rule cannot be overcome by fractions rule compliance. A sale of condominium units as a block may remedy this problem.

REITs

For a TEO that is interested in investing in real estate and avoiding UBTI but wants less exposure to the tax risks of the activities of a partnership, that wants greater transferability of its interests in the investment, or that wants to invest in an entity with more experience in real estate investing, one option is to invest in a real estate investment trust ("REIT"). REITs have significant organizational requirements, so depending on the size of the transaction, the TEO may not be interested in organizing a REIT. If, instead, the TEO is interested in investing through an already existing REIT, such investing carries some advantages and some risks.

An entity must meet several organizational tests to qualify as a REIT. It must be managed by one or more trustees or directors. §856(a)(1). The beneficial ownership must be evidenced by transferable shares or certificates. §856(a)(2). But for REIT qualification, the investment vehicle must be taxable as a corporation. §856(a)(3). It may not be a financial institution or an insurance company. §856(a)(4). Beneficial ownership of the REIT must be held by 100 or more persons. §856(a)(5). The entity may not be a closely held corporation as defined in section 856(h). §856(a)(6). It also must meet the income tests described below. §856(a)(7).

REITs are entities that generally avoid taxation by mechanism of the dividends-paid deduction. §§857(a); 561. If the REIT fails to meet certain "good income" tests such as 90 percent passive income and 75 percent real estate income (or any of the other organizational tests of section 856(a)), it may lose its qualification as a pass-through entity and be subject to taxation at regular corporate tax rates. §856(a)(3). Furthermore, if the REIT engages in certain prohibited transactions, such as selling property held for the purpose of sale to customers in the ordinary course of business, such income is subject to a 100 percent penalty tax. §857(b)(6).

Risks For Some TEOs

Investing in REITs that comply with the basic technical requirements will yield dividends exempt from UBTI under section 512(b)(1) or exempt capital gains dividends under section 512(b)(5). However, this is not the case for all TEOs and all REITs. Qualified pension trusts are at some risk of UBTI if they invest through REITs that are pension-held REITs under section 856(h)(3)(C). REITs are required to have beneficial ownership by at least 100 persons. §856(a). As a general rule, REIT stock owned by a qualified pension trust is treated as owned proportionately by the beneficial owners of the qualified pension trust. §856(h)(3)(A). There is an exception to this rule for REITs that qualify for REIT status only because of the look-through treatment of section 856(h)(3)(A). These REITs are considered pension-held REITs if any one qualified pension trust owns more than 25 percent of the interests in the REIT or if any group of qualified pension trusts, each owning more than 10 percent of the interest in the REIT, own in the aggregate more than 50 percent of the interests in the REIT. §856(h)(3)(D). If a REIT is pension-held and the qualified pension trust owns more than 10 percent of the interests thereof, it must include a proportion of its dividends as UBTI based on the proportion of all REIT income that would be UBTI if held directly by a qualified pension trust (i.e., if the REIT had not been interposed). §856(h)(3)(C). The significant results are that the qualified pension trust may lose the advantages of some of the more liberal rules for tenant services applicable to REITs, discussed hereinafter, or that it becomes subject to the unrelated debt-financed income rules. A qualified pension trust, as a qualified organization under section 514, should generally be immune from unrelated debt-financed income, unless, for instance, the REIT itself owned its interests in real estate through a partnership which is not fractions-rule compliant. This may sometimes be the case

when the REIT is used to provide a promote allocation to the TEO in what is sometimes called a "blocker."

Greater Investment Opportunities

If the TEO is able to take full advantage of REIT investment, it may find itself in some ways able to participate in a greater variety of investment opportunities. REITs may directly or indirectly provide greater services without resorting to a net lease. The key concern of a REIT is usually not UBTI but instead impermissible tenant services income. Income that is due to impermissible tenant services is not "good" rental income for purposes of the organizations tests. §856(d)(2)(C). Moreover, if more than one percent of amounts received with respect to a property are from impermissible tenant services income, then all the rental income from the property may be disqualified from classification as rental income.

A REIT may directly provide the same services as may be provided under the UBTI rules in connection with rented real property that are customary, without the rent being deemed impermissible tenant services income. §856(d)(7)(C)(ii). It may provide expanded tenant services beyond what is permitted under the UBTI rules, such as attended parking, as long as they are provided by an independent contractor, and not have such income deemed impermissible tenant services income. §856(d)(7)(C)(i); Rev. Rul. 2004-24, 2004-10 I.R.B. 550. Moreover, even if the REIT must lease a property to avoid directly conducting business operations, it has the option of leasing to a ready-made subsidiary, thus avoiding the trouble of finding another lessee in the marketplace.

With respect to the transactions contemplated by this article, perhaps the greatest difference in outcome exists with respect to hotels. In fact, there are REITs called hotel REITs. Although hotels would usually be considered to be too active a business and require too many services to be good rental income, REITs are permitted to own taxable REIT subsidiaries ("TRS"), provided that TRS securities account for no more than 20 percent of the assets of the REIT. A TRS is taxable as a corporation at section 11 rates and qualifies as a TRS if it makes the proper elections. §856(l). A REIT may then lease a hotel building to a TRS, thus receiving good rental income. §856(d)(8)(B). The TRS itself may not operate or manage the hotel, but is permitted to hire an eligible independent contractor provided that such independent contractor was already in the business of managing hotels. §856(d)(9)(A) (Also provided that the hotel does not permit wagering activities on its premises, i.e., is not a casino. §856(d)(9)(D)(i).) Although it is also true that similar results could be achieved by means of a net lease by the TEO, the existence of the TRS eliminates one layer of transaction costs.

For office buildings, investing through a REIT may be only marginally advantageous at best. Because of the liberalized rules regarding tenant services, both by independent contractors and by TRS entities, a REIT can offer more investment opportunities. On the other hand, its marginal advantage may be offset by certain organizational inefficiencies such as the complex REIT organizational requirements.

It is also questionable how much more advantageous a REIT is in the case of a condominium development, As discussed above, income from sale of units will be subject to a 100 percent penalty tax, a far worse outcome than UBTI. Also, its status as property held for sale to customers may also make interim rental income fail to be good rental income and thus risk losing the pass-through status of the REIT. There are safe harbors that could at least allow some rental income to be regarded as good income and the property not yet of a suspect class. The problem is that to qualify for the safe harbor, the

REIT must hold the property for four years, which may be longer than certain investors' desire to hold a particular condominium property before selling units.

C Corporations

One traditional investment vehicle, really the classic vehicle, is the C corporation. It has the drawback that the taxable C corporation is subject to section 11 taxation and upon liquidation it is subject to such corporate tax on deemed sale of assets by reason of Treas. Reg. §1.337(d)-4, which in most instances will be fatal to the economics of the transaction. At least there is the consolation that dividends, interest, and capital gains from disposition of stock have always been exempt under the passive exceptions (except when ownership of such stock is debt-financed). §512(b)(1), (b)(5).

Additional concerns may arise when a TEO, particularly a nonprofit organization, is the sole shareholder of a C corporation. However, the weight of authority issued by the Service is that there is generally no attribution of assets or activities of the subsidiary to the nonprofit organization parent. 1998 WL 1984795; GCM 39776; GCM 39598; GCM 39326. As long as the subsidiary has its own business purpose and the nonprofit organization is not so involved in the day-to-day management that the subsidiary is effectively a guise, arm, agent, or alter ego of the nonprofit organization parent, the subsidiary's independent existence should be respected.

Respecting the independent existence of the taxable subsidiary is particularly important with respect to certain investments in real estate. In TAM 9340002, a nonprofit organization exempt under section 501(c)(3) owned a C corporation that owned a hotel. The Service determined that the activities of the subsidiary would not jeopardize the tax-exempt status of the nonprofit organization.

S Corporations

With recent changes in the law, the S corporation is now an available form for TEO investments. This is less an opportunity than a trap for the unwary as all income received from an S corporation and proceeds on sale of S corporation stock is UBTI to the TEO, thus succeeding in creating an even worse investment vehicle than a C corporation. 512(e)(1). Therefore, other than when a nonprofit organization receives S corporation stock as a gift, the practitioner should seriously question whether owning property through an S corporation is economically efficient.

CONCLUSION • As this article has demonstrated, how a real estate investment is structured can make a significant difference in the tax outcomes for the TEO investing in real estate. These outcomes are based on the evolution of several currents of federal tax law and would never have been the design of a policy-maker consciously considering the taxation of TEOs. Until such time as the law governing taxation of these investments is streamlined, practitioners must be sensitive to the opportunities and traps that accompany these investments in the three fact patterns discussed.

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PRACTICE CHECKLIST FOR:

The ABCs of UBTI: A Practical Guide To Avoiding Unrelated Business Taxable Income From Real Estate Investments

The unrelated business income tax ("UBIT") imposes the section 11 corporate tax rates on the unrelated business taxable income ("UBTI") of tax-exempt organizations ("TEOs"). Short of outright disqualification as a TEO, imposition of the UBIT is the most important financial consequence a TEO can experience. Practitioners advising TEOs must know the rules, and the choices those rules present to their clients.

• UBTI generally is a tax on income from unrelated business operations and rentals of property purchased with borrowed funds. But there are exceptions:

__ If the income is exempt-function income, it is not UBTI;

__ If the TEO is a qualified pension trust or nonprofit educational institution, it may invest in debt-financed real estate;

__ If the TEO invests in partnership investments in real property when (1) the allocations meet the substantial economic effect rule of Code section 704; and (2) subject to exceptions, no partner that is a qualified organization could receive an allocation of a share of income for any taxable year greater than such qualified organization's smallest share of losses for any taxable year (the fractions rule).

• Before analyzing the applicable law regarding TEOs, the practitioner must get comfortable regarding all aspects of the transaction.

__ First, it is important to understand the client. The attributes of the client will sometimes determine which type of investment is optimal and the procedures for effecting such investment.

__ Second, it is important to understand the deal. In addition to understanding the broad outlines of the deal, it is important to know what services and amenities will be provided to those using the real estate, and by whom. Depending on the deal and the choice of investment vehicle, a TEO may find that some percentage of its investment, or even all of its investment, is subject to UBIT on some level of the deal.

__ Practitioners who represent clients on such transactions should have developed a standard questionnaire designed to flesh out these issues. It is the responsibility of the practitioner to sensitize the client to the importance of fully responding to the questionnaires.

• Consider carefully the investment vehicle:

__ Direct investing;

__ Partnerships;

__ REITs;

__ C Corporations; and

__ S Corporations.