REPORT #688

TAX SECTION

New York State Bar Association

Report on Unrelated Business Income Taxation of
Income from Interest Rate Swaps and Similar Instruments

April 26, 1991

Table of Contents

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The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
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3120 Main Treasury
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Dear Mr. Gideon:

I enclose our report on Unrelated Business Income Taxation of Income from Interest Rate Swaps and Similar Instruments. The members of the Committee on Tax Exempt Entities who prepared this report are Harvey P. Dale and Franklin L. Green, Co-Chairs, and Ronald A. Lehmann and Stephen Zorn.

Our report recommends that income from interest rate swaps and similar financial instruments generally be exempt from the unrelated business income tax ("UBIT"). More specifically, we support (1) the publication of a revenue ruling holding that a tax-exempt entity's income from a notional principal contract is not subject to the UBIT (provided the tax-exempt is not a dealer in such contracts, and the cost of acquiring such contract is not debt-financed) and (2) the promulgation of a statutory or regulatory amendment providing that income derived by a tax-exempt in connection with acquiring, holding or disposing of securities or other financial instruments (again in a non-dealer capacity and subject to the debt-financed property rules) is exempt from the UBIT.

We hope this report will be useful to you in considering the UBIT's application to swaps and other financial instruments.

Very truly yours,

James M.J Peaslee
Chair

Enclosure

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Tax Report #688

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON TAX-EXEMPT ENTITIES

Report on Unrelated Business Income Taxation of Income from Interest Rate Swaps and Similar Instruments

April 26, 1991

Introduction[1]

Section 511 of the Internal Revenue Code[2] taxes the unrelated business taxable income of tax-exempt entities ("tax-exempts").[3] Section 512(b) excludes from the reach of this unrelated business income tax ("the UBIT") most common forms of passive investment income, including interest and dividends. In a Private Letter Ruling issued in July 1990, the Internal Revenue Service ("the Service") concluded that a tax-exempts income from interest rate swap payments was also not subject to the UBIT. Several months later, however, the Service announced that it was "reconsidering" the ruling, casting doubt on whether tax-exempt's income from interest rate swaps, as well as their income from other forms of portfolio investments not known or prevalent when Congress enacted the UBIT provisions, is excluded from the UBIT's ambit.

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[1] The members of the Committee on Tax Exempt Entities who prepared this Report are Harvey P. Dale and Franklin L. Green, Co-Chairs, and Ronald A. Lehmann and Stephen Zorn. Helpful comments were received from Dale S. Collinson, John A. Corry, Arthur A. Feder, Kenneth H. Heitner, Edward D. Kleinbard, Charles M. Morgan III, Ronald A. Pearlman, James M. Peaslee, David Sachs, and Willard B. Taylor.

[2] "Section" or "§" refers to sections of the Internal Revenue Code of 1986, as amended, and to regulations promulgated there-under.

[3] Tax-exempt organizations other than trusts are taxed at corporate rates; tax-exempt trusts are taxed at individual rates. §§ 511(a), 511(b).

As discussed below, we believe that a tax-exempt's income from notional principal contracts, earned in connection with its investment activities, should not be subject to the UBIT; in our view, therefore, the Service should publish a revenue ruling similar to the private letter ruling currently under reconsideration. We also believe, however, that the uncertainty surrounding such income underscores the need for clarifying the UBIT consequences of other non-traditional forms of portfolio income. We therefore support a statutory or regulatory amendment providing in general that income derived by a tax-exempt in connection with acquiring, holding, or disposing of securities or other financial products in a non-dealer capacity should be exempt from the UBIT. We believe that the Service has authority to adopt a regulation along these lines.

I Legislative Background

A. Statutory Framework

The core of the UBIT rules is § 512(a)(1), which defines a tax-exempt's unrelated business taxable income as its

> gross income derived . . . from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

This language provides that if a tax-exempt's investment activities constitute an unrelated trade or business that the tax-exempt regularly carries on, the income those investments produce will be subject to the UBIT unless it falls within one of the § 512(b) “modifications.” Those modifications exclude from the UBIT interest, dividends, payments with respect to loans of securities, royalties, most rents, and gains from dispositions of non-inventory property. See generally § 512(b)'. If a tax-exempt’s investment activities do not constitute a trade or business, however, the income they produce is not in any event subject to the UBIT, without regard to whether that income comes within one of the § 512(b) modifications.

B. Legislative Purpose

When it enacted the UBIT, Congress announced its purpose clearly:

> The problem at which the tax on unrelated business income is directed here is similarly that of unfair competition. The tax-free status of these section [501(c)] organizations enables them to use their profits tax-free to expand 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 exemption to buy an ordinary business. . . .
>
> Your committee’s bill does not deny the exemption where the organizations are carrying on unrelated active business enterprises, or require that they dispose of such businesses, but merely imposes the same tax on income derived there-from as is borne by their competitors.

H. Rpt. No. 2319, 81st Cong., 2d Sess., reprinted in 1950-2 C.B. 380, 409 (emphasis added); see also S. Rpt. No. 2375, 81st Cong., 2d Sess., reprinted in 1950-2 C.B. 483, 505. The regulations are in accord. Reg. § 1.513-1(b). Congress' desire to discourage tax-exempts from “trading in the tax exemption,” H. Rpt. No. 413, 91st Cong., 1st Sess. 44 (1969), underlay Congress' 1969 amendment of the UBIT to encompass debt-financed income, particularly when that income arose from sales of business property to tax-exempts that leased the property back to a new corporation operated by the original seller. Prior to the 1969 amendment, this device had enabled tax-exempts to acquire businesses “while contributing little or nothing themselves to the transaction other than their tax exemption,” id. at 19, and allowed business owners to realize substantial capital gain, rather than ordinary income, id. at 45 (discussing Commissioner v. Brown, 380 U.S. 563 (1965)).

C. Prior Amendments

Upon enacting the UBIT, Congress laid down a general principle for not taxing a tax-exempt's investment income:

> The tax applied to unrelated business income does not apply to dividends, interest, royalties (including, of course, overriding royalties), rents (other than certain rents on property acquired with borrowed funds), and gains from sales of leased property. Your committee believes that such “passive” income should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations.

H. Rpt. No. 2319, supra, 1950-2 C.B. at 409 (emphasis added); see also S. Rpt. No. 2375, supra. 1950-2 C.B. at 506. In the 1970's, however, Congress twice amended the UBIT rules to deal directly with forms of investment that it had not envisioned or that were not common in 1950.

In 1976, Congress amended § 512(b)(5) expressly to exclude-from the UBIT "all gains on the lapse or termination of options, written by the organization in connection with its investment activities, to buy or sell securities." Prior to this amendment, tax exempts could not be certain that such gains fell within any of the existing § 512(b) "modifications." Until Congress added this specific exclusion, tax-exempts ran the risk that the Service would -- or could -- treat the gains as trade or business income that § 512(b) did not exempt from the UBIT. Congress expressly meant for this legislation to override Rev. Rul. 66-47, 1966-1 C.B. 149, which had treated a tax-exempt's gains from its writing of call options as unrelated trade or business gains subject to the UBIT. See s. Rpt. No. 1172, 94th Cong., 2d Sess., reprinted in 1976-2 C.B. 531, 533.[4] In reporting on § 512(b)(5),

[4] Rev. Rul. 66-47 implicitly rejected the tax-exempt's reliance on Higgins v. Commissioner, 312 U.S. 212 (1941), which had held that a taxpayer's full-time management of his investment interests did not constitute a trade or business.

the Senate Finance Committee explained that “[t]axing . . . income [from the lapse or termination of options] is inconsistent with the generally tax-free treatment accorded to exempt organizations' income from investment activities.” S. Rpt. No. 1172, supra, 1976-2 C.B. at 533.

Two years later, the Service relied on Congress' 1976 statement of intent as a basis for Rev. Rul. 78-88, 1978-1 C.B. 163, which considered the tax ramifications of a tax-exempt’s temporary loans of securities to a brokerage house secured by collateral of equal value, pursuant to a contract requiring the brokerage house to pay the tax-exempt an amount equal to the dividend or interest the tax-exempt would have earned on the securities and an additional premium. The Service concluded that the tax-exempt's income was not subject to the UBIT in light of the legislative history of amendments to § 512(b)(5), which it said indicated that “Congress does not intend for ordinary or routine investment activities of a section 501(a) organization in connection with its securities portfolio to be treated as the conduct of a trade or business for purposes of section 513.” 1978-1 C.B. at 164. Thus, rather than trying to force the income derived from lending securities into one of the § 512(b) modifications, the Service excluded the income on the more general grounds of the absence of a trade or business.

In the same year as the Service's issuance of Rev. Rul. 78-88, Congress concluded that its declared intention in the legislative history to the 1976 amendment to § 512(b)(5) -- not to subject tax-exempts' investment income to the UBIT -- did not sufficiently protect the income tax-exempts received from lending their securities. Noting the “uncertainty” surrounding the tax treatment of securities loans and seeking “to clarify existing law,” see S. Rpt. No. 762, 95th Cong., 2d Sess. 4, 7 (1978), Congress added a specific “modification” to § 512(b)(1) for securities loans, with a conforming definition in § 512(a)(5).[5] These additions excluded from unrelated business taxable income a tax-exempt's income from fully collateralized loans of its securities.[6]

In both 1976 and 1978, then, the trade or business standard of § 512(a)(1) proved too uncertain to protect tax-exempts engaging in non-traditional financial transactions from the UBIT. Rather than having taxpayers rely on Service rulings or statements of legislative intent, Congress amended the Code to respond to these developments. In 1978, the Senate Finance Committee

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[5] The Senate Finance Committee, however, had ordered a report of the bill amending § 512(b)(1) several weeks before Rev. Rul. 78-88 was issued, indicating that Congress had independently reached the same conclusion as the Service with regard to securities loans by tax-exempts.

[6] Prior to this amendment and the issuance of Rev. Rul. 78-88, practitioners had noted the risk that such loans constituted a trade or business whose proceeds were not included in one of the § 512(b) exclusions and were, therefore, subject to the UBIT. See, e.g., Stern & Sullivan, Exempt Organizations Which Lend Securities Risk Imposition of Unrelated Business Tax, 45 J. Tax. 240 (1976).

recommended a statutory change, even while noting that it believed the conclusion of Rev. Rul. 78-88 was correct. See S. Rpt. No. 762, supra. at 8. Congress may have feared that the revenue ruling alone, without an appropriate conforming statutory amendment, would lead tax-exempts fearing a narrow construction of the ruling not to undertake transactions that, while prudent, were not identical to the one the ruling considered.

Thus, as tax-exempts have undertaken investments unknown or not prevalent in 1950, Congress has updated the UBIT rules by statute to remove doubt that such transactions constitute a trade or business unrelated to the organization's exempt purpose.

II. Interest Rate Swap Income Under the UBIT

A. Definition and Description

As the size of tax-exempts' investment portfolios, the sophistication of tax-exempts' investment managers, and the variety of investments available to tax-exempts have increased, many larger tax-exempts have entered into various types of "swap," or other notional principal, instruments. In their simplest form, interest rate swaps represent the exchange of one stream of interest income for another. For example, a tax-exempt holding a bond that pays variable-rate interest (perhaps keyed to LIBOR or the U.S. prime rate) may wish to increase the predictability of its income by exchanging that variable interest stream for an income stream calculated at a fixed rate on the same principal amount. The tax-exempt would, in such a case, engage in a swap transaction, either directly with another institution ("the counterparty") or through a financial intermediary, in which the tax-exempt promises to pay the counterparty the amounts it is entitled to receive as variable-

rate interest payments and, in return, the counterparty pays the tax-exempt a series of fixed-rate payments.

Variations on this basic scheme are numerous. One party to a swap may make a single initial payment and receive a stream of payments in return, or the payment streams may be subject to caps, floors, or other limitations, or have option features. In addition, a tax-exempt investing in foreign-currency-denominated debt instruments may choose to exchange its right to interest payments in the foreign currency for payments in U.S. dollars. In that case, it would enter into a currency swap, effectively converting its interest into a dollar-denominated obligation. In some cases, both currency and interest rate swaps are combined in a single instrument, enabling the tax-exempt, for example, to exchange a right to variable-rate foreign currency interest payments for fixed-rate U.S. dollar payments.

In general, no special rules govern the character of interest rate swap income. Usually, therefore, swap payments under an interest rate swap contract result in ordinary income, and gain or loss on the transfer of a swap contract results in capital gain or loss. In Notice 89-90, 1989-2 C.B. 407, however, the service announced that final regulations under § 954 will provide that income attributed to most notional principal contracts denominated in the taxpayer's functional currency, including interest rate swaps, will be treated as income equivalent to interest for subpart F purposes.[7] This ruling might

[7] Until those regulations are issued, interest rate swaps generate income equivalent to interest when they are part of an integrated transaction giving rise to income equivalent to interest. See Notice 89-90, 1989-2 C.B. at 408.

support by analogy an argument for treating interest rate swap payments as income equivalent to interest for UBIT purposes.[8]

B. Private Letter Ruling 9042038

Private Letter Ruling 9042038 (July 23, 1990) considered whether a tax-exempt organization's income from interest rate swaps is subject to the UBIT. The ruling involved a typical swap transaction in which the tax-exempt entered into a swap that effectively converted a floating rate debt security it held into a fixed rate security. The Service's conclusion that the swaps did not generate unrelated business taxable income rested on the determination that the swaps were "ordinary or routine investment activities undertaken in connection with the management of [the tax-exempt's] securities portfolio." Such activities, in the Service's view, "are not treated as the conduct of a trade or business for purposes of section 513." PLR 9042038. Thus, the Service exempted the tax-exempt's swap income from the UBIT on the grounds that the swaps were not held in a trade or business activity of the tax-exempt entity. By holding that the tax-exempt's swap transactions did not constitute a trade or business, the Service avoided having to determine whether the income there-from qualified for any of the § 512(b) exemptions from the UBIT.

Three months after issuing PLR 9042038, however, the Service announced that it was "reconsidering" the ruling. See Private Letter Ruling 9046066 (Oct. 26, 1990); Announcement 90-134, 1990-50 I.R.B. 18. The reconsideration calls into question whether interest rate swap income is exempt from the UBIT. A new ruling imposing the UBIT on such income could, if broadly framed,

[8] Unlike § 954(c), however, § 512(b) does not contemplate a specific category of income denoted as "income equivalent to interest."

indicate that the Service intends to tax all of a tax-exempt's investment income that is neither “plain vanilla” interest or dividend income, nor is otherwise expressly included in a § 512(b) modification.

C. Trade or Business Requirement

As PLR 9042038 illustrated, the UBIT may be imposed only on investment activities that constitute a trade on business. It seems likely that most tax-exempt's investment activities fall short of the trade or business threshold.

Reg. § 1.513-1(b) provides the basic parameters of the trade or business requirement:

> (b) Trade or business. The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. . . . Accordingly, for purposes of section 513 the term “trade or business” has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods and performance of services.

Reg. § 1.513-l(b) (emphasis added). This standard relates the existence of a trade or business to competitive activity, specifically including the sale of goods and the performance of services. Although it does not indicate clearly that competitive activity is a necessary element of the definition of a trade or business, this regulation may be more restrictive than its predecessor, which stated simply that the term “trade or

business" had the same meaning in the UBIT context as in § 162. See Reg. § 1.513-2(a)(1).[9]

Similarly, Reg. § 1.513-1(c) defines when a trade or business is "regularly carried on" (and thus is subject to the UBIT) in terms of the commercial nature of the fenterprise.[10] A tax-exempt's investment activities must "manifest a frequency and continuity, and [be] pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations" in order to meet the regularity test. Reg. § 1.513-1(c)(1) (emphasis added). The regulatory structure suggests, therefore, that a tax-exempt's portfolio investment activities should be exempt from the UBIT.

Section 162[11] and its associated jurisprudence provide little additional guidance, however, as to the criteria defining a trade or business. In a recent case dealing with the deductibility of gambling losses, the United States Supreme Court stated that determining whether an activity qualifies as a trade or business under § 162 "requires an examination of the facts in each case." Commissioner v. Groetzinger, 480 U.S. 23 (1987) (citing Higgins v. Commissioner, 312 U.S. at 217). Any more specific guidance on this question, the Court indicated, would have to come from Congress. Id. at 87,287-88.

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[9] Rev. Rul. 66-47, supra. 1966-1 C.B. at 149, which taxed income from expiring options, was issued under the old rules, which remain applicable to taxable years beginning before December 13, 1967. As discussed above, Congress changed this result by statute in 1976.

[10] In another context, Congress in legislative history has indicated that even a tax-exempt pension trust may be deemed to carry on the "business of lending money" if it does so "actively and regularly." See § 465(b)(6)(D) (cross-referencing § 49(a)(1)(D)(iv)); S. Rpt. No. 313, 99th Cong., 2d Sess. 749 (1986).

[11] Section 162 generally allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

Precedent specifically considering the treatment of investment income under § 162 is scarce and outdated. Higgins, for example, denied a deduction for expenses incurred by a taxpayer in managing his own investments. 312 U.S. at 217. The Court's holding implied that such activities do not constitute a trade or business. A year later, however, Congress enacted the predecessor of § 212, which preserves the deductions denied by Higgins, without commenting explicitly on whether such investment management constitutes a trade on business.[12] See H. Rpt. No. 2333, 77th Cong. 1st Sess., reprinted in 1942-2 C.B. 372, 429-30; S. Rpt. No. 1631, 77th Cong. 2d Sess., reprinted in 1942-2 C.B. 504, 570-71; see also City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121 (1941); United States v. Pyne, 313 U.S. 127 (1941) (holding that the efforts of an estate or trust in asset conservation or maintenance do not constitute a tra3e or business), Estate of Yaeger v. Commissioner, 889 F.2d 29 (2d Cir. 1989) (holding similarly); but see Snyder v. Commissioner, 295 U.S. 134 (1935) (suggesting that a trader who makes a living buying and selling 13 securities could deduct trading expenses).[13]

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[12] A number of authorities support the view that investment activity carried on by a tax-exempt (or indeed even by a taxable corporation, see GCM 37313 (Nov. 7, 1977) (views of Commissioner Kurtz)), does not necessarily constitute a trade or business. See Rev. Rul. 78-88, supra (holding that securities lent by tax-exempt as part of its investment activity not held for sale to public as part of tax-exempt's trade or business). See also Howell v. Commissioner, 57 T.C. 546 (1972) (corporate form respected even though corporation's only property holdings are investment assets); Rev. Rul. 75-188, 1975-1 C.B. 276 (same); cf. Rev. Rul. 75-523, 1975-2 C.B. 257. These authorities, however, should be contrasted with GCM 39615, discussed below in the text.

[13] In a related area, when Congress wished to encourage foreign investment in U.S. securities, and was concerned that the uncertain scope of the trade-or-business concept was exerting a chilling effect, it adopted a safe-harbor rule stating that such activities would not constitute business activities. § 864(b)(2)(A)(ii).

One Service pronouncement that warrants special mention is GCM 39615, issued in 1987. On its face, this GCM permitted a tax-exempt to engage in index arbitrage transactions without giving rise to unrelated business taxable income on the theory that each leg of the transaction was exempt under § 512(b). However, the following passage in that GCM has had a chilling effect on the financial products market:

> More specifically, these proposed rulings are that, in the absence of debt financing, the Foundation's arbitrage transactions will not result in [unrelated business taxable income] because they will not constitute the carrying on of an unrelated trade or business. This position appears to rely on cases cited by the Foundation to the effect that investment activity does not rise to the level of a trade or business no matter how actively carried on. All of those cases, however, involved individual taxpayers. When applied to an exempt organization, the term 'trade or business' encompasses an [sic] profit-motivated activity, under the rationale of **** GCM 37513, 1-4904 (April 25, 1978, subsequently upheld in Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982). Moreover, the Foundation's proposed trading activities would be an 'unrelated' trade or business that is 'regularly carried on'.

Characterizing the activity proposed by the tax-exempt in GCM 39615 as a trade on business would effectively eliminate the trade or business requirement of § 512 and result in the treatment as unrelated business taxable income of every source of income from a profit making activity undertaken by a tax-exempt entity absent a specific safe harbor.

The language of Reg. § 1.513-1(c)(1), linking a regular trade or business to competitive activity, would suggest that

the Service is now following the rule that management of an organization's own investments is not a trade or business. This view seemed to underlie Rev. Rul. 78-88 and PLR 9042038, both of which resolved open UBIT questions concerning investment income in favor of the tax-exempt on the grounds that the investment activity at issue was not a regular trade or business. Although clearly dicta, the passage from GCM 39615 maintains, however, that investment activity of a tax-exempt is always a trade or business.

The foregoing discussion indicates that in claiming that certain investment activities do not amount to a regular trade or business, tax-exempts run a risk of imposition of the UBIT under current law because of the highly factual nature of the trade-or-business and regularity determinations, as well as 14 the Service's conflicting signals on the issue.[14]

III. Proposal

We noted above that Congress, consistent with the Supreme Court's reluctance to establish criteria defining a trade or business, has in the past amended § 512(b) to clarify that certain types of investment income should not be treated as trade or business income. In our view, such clarification is again appropriate, either by regulation or by statutory amendment. First, although strong arguments can be advanced for the

[14] Reg. § 1.513-1(c)(2)(ii) states that “exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.” As noted above, a tax-exempt's investment activities are “regularly carried on” if they are carried out in a manner and with a frequency “generally similar to comparable commercial activities.” Reg. § 1.513-l(c)(1).

proposition that income from interest rate swaps and like investments do not constitute trade or business income, the factual nature of that determination leaves the conclusion somewhat uncertain, particularly in light of the Service's reconsideration of PLR 9042038. Second, none of the § 512(b) UBIT exclusions applies on its face to income from interest rate swaps or similar financial products, such as currency swaps or forward or futures contracts.[15] Despite some authority suggesting that interest rate swap income is income equivalent to interest for subpart F purposes, see Notice 89-90, discussed supra, that principle has not been applied in the UBIT context.[16] Similarly, while the Code states that exchange gain or loss from currency swaps shall be treated as interest to the extent provided in regulations, see § 988(a)(2), the regulations exercise this authority only in specific circumstances, including integrated financial transactions involving functional and nonfunctional currency instruments, see Reg. § 1.988-3T(c)(1) (referring to Reg. § 1.988-5T).[17] It is difficult to conclude, therefore, that the current § 512(b) exclusions clearly protect a tax-exempt's regular income from swaps and similar investment instruments (except as indicated in footnote 15) from the UBIT.

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[15] To the extent that such income constitutes income from the sale, exchange, or disposition of non-dealer property, however, § 512(b)(5) would exclude the income from the UBIT. Income from commodity swaps, for example, may be treated as income from the sale or exchange of property because of § 1234A, and the same may be true for futures contracts and certain other instruments under § 1256.

[16] We understand, moreover, that in a yet-to-be published private letter ruling, the Service has held that interest rate swap income does not constitute interest or any other type of personal holding company income. In effect, the Service refused to expand the traditional classifications of personal holding company income to include the income from notional principal contracts.

[17] Where a nonfunctional currency instrument is hedged with a dollar instrument and treated as a single dollar denominated instrument under § 988(d), all income recognized by the holder appears to be interest income that is not subject to the UBIT. See Reg. § 1.988-5T(a)(9) (discussing synthetic debt instruments).

In light of the uncertain limits of the trade or business requirement, we believe that clarification of the UBIT ramifications of "non-traditional" forms of investment income is necessary. Consequently, we support the publication of a revenue ruling holding, similarly to PLR 9042038, that income from notional principal contracts is not unrelated business taxable income (provided the tax-exempt does not enter into the contract in connection with activities as a dealer in such instruments, and no part of the cost of acquiring such contract is debt-financed).[18] Although it may be possible to limit the exception to swaps held as hedges for cash flows for specific investments, we do not recommend such a limitation.[19] We also favor refining the UBIT rules, either by regulation or statute,[20] to exclude from the UBIT income derived in connection with the activity of acquiring, holding, or disposing of "securities," as defined in §

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[18] For a definition of notional principal contract, see Reg. § 1.863-7T. In the instant context, however, that definition should be modified to remove the limitation that payments be made in the tax-exempt's functional currency. In addition, see Reg. § 1.954-2T(a)(4)(iii) for a definition of a dealer in notional principal contracts.

[19] A tax-exempt could enter into a swap that was not tied to a particular investment as part of an overall portfolio management strategy. The requirement that the swap not be held by the organization as a dealer adequately polices the line between commercial and investment activity. Cf. § 512(b)(5) (gain from sales of non-dealer property not subject to UBIT).

[20] The Service clearly has adequate authority to issue regulations to this effect. Developments in portfolio management and investment techniques make regulations dealing with those changes "needful" in the UBIT context and thus within the Secretary's authority under § 7805(a). The Service exercised similar regulatory authority in Reg. § 1.892-3T(a)(4), which defines a "financial instrument" for purposes of Reg. § 1.892-3T(a) (and, by extension, § 892(a) of the Code) to include, in part, "any forward, futures, options contract, swap agreement or similar instrument in a functional or nonfunctional currency....". Under § 892(a), income of foreign governments received from investments in the United States in financial instruments held in execution of governmental financial or monetary policy is excluded from the foreign government's gross income for U.S. tax purposes.

1236(c),[21] or other financial instruments,[22] in a capacity other than as a dealer. Such a broadly framed provision would include income from activities incident to the management of a tax-exempt's securities portfolio, such as commitment fees, and would obviate the need for further amendments as new financial products develop.[23] At the same time, however, by limiting the proposal's scope to transactions not involving dealer activities, we hope to ensure that tax-exempts do not run afoul of the concern underlying the UBIT for preserving the competitiveness between tax-exempt and tax-paying entities.

We believe our recommendation is consistent with the competitiveness concerns underlying the UBIT rules. Tax-free treatment of income from ordinary or routine investments that are non-traditional in form, such as interest rate swaps, is no more

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[21] Section 1236(c) defines a “security” as “any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.” In the present context, references to a tax-exempt's securities portfolio should be construed to include the tax-exempt's mortgage portfolio as well.

[22] For a possible definition of “financial instrument,” see Reg. § 1.892-3T(a)(4) discussed above in footnote 20. We do not believe that an exception only for “securities” as defined in § 1236(c) would be adequate; the point of the proposed exclusion is to anticipate innovative changes in the financial markets, and those changes could well involve financial instruments that do not qualify as “securities.” Clearly, however, the proposed rule does not override the special rules for partnership investments found in § 512(c) or, of course, § 514.

[23] Section 851(b)(2) contains a similarly broad test, subjecting a corporation to the rules governing regulated investment companies if 90 percent of its gross income takes one of several forms, including “income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies.” No regulations pursuant to this particular provision have yet been issued, however.

anti-competitive than tax-free treatment of income from securities loans or the writing of options. In- these portfolio investments, neither the tax-exempt nor its swap or contract counterparty obtains any benefits or advantages (other than the intended benefit of the tax-exempt's freedom from tax on investment earnings) from the fact that a tax-exempt is a party to the transaction.[24] Stated differently, the proposal is limited to portfolio investments that may well require a measure of investor sophistication but are not structured to take unwarranted advantage of the tax-exempt's special status.[25] Indeed, our experience suggests that the parties who might be thought to have the greatest concerns over competition from entities engaging in transactions in financial products, such as investment or commercial banks, are likely to welcome our proposal, since they view tax-exempts as potential customers

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[24] The § 512(b)(5) exclusion of gains or losses from the sale or exchange of non-dealer property suggests that a tax-exempt's gains or losses on commodity swaps or other exotic investments are exempt from the UBIT. We see no policy reason for treating differently interest rate or currency swaps undertaken by tax-exempts; indeed, it would be paradoxical if income from uncommon investments were exempted from the UBIT by § 512(b)(5) while income from more traditional investments, such as interest rate or currency swaps, were taxable to a tax-exempt. Similarly, tax-exempts' income from futures and options that in effect create “synthetic swaps” should be subject to the same tax rules as the swaps themselves. Our proposal would achieve that result in a manner consistent with Service precedent indicating that such investments are likely not to generate income subject to the UBIT. See Private Letter Ruling 8832052 (May 18, 1988) (tax-exempt's arbitrage income from offsetting positions in stock index futures and underlying index stocks excluded from UBIT pursuant to § 512(b)(5)); Private Letter Ruling 8708031 (Nov. 25, 1986) (same); GCM 39615 (Mar. 12, 1987) (same); Private Letter Ruling 8338138 (June 24, 1983) (pension plan's investment in regulated commodity futures contracts does not generate income subject to UBIT).

[25] In this regard, the mere fact that certain forms of investments such as zero-coupon bonds are more attractive to tax-exempts than to other types of investors should not subject the investment to the UBIT. Similarly, swaps in which the tax-exempt receives a lump-sum payment, rather than an income stream, should not be subject to the UBIT. Of course, in an extreme case where a swap is characterized as debt under general tax principles, the issuance of the debt could result in taxation of income from other assets financed with the up-front payment received. See generally § 514.

rather than competitors. Finally, the rule we recommend would not shelter non-passive activities or business enterprises from the excess business holdings rules of § 4943. See § 4943(d)(2) (defining business enterprise in terms of non-passive source income); S. Rpt. No. 762, supra, at 8 n.6 (noting that lending of securities would not transform an investment activity into a trade or business subject to § 4943).

IV. Evolution of the Prudent Man Standard

Our proposal for exempting "new" forms of investment income from the UBIT would provide tax-exempts with greater flexibility in managing their portfolios in accordance with the "prudent investor" rule, considered in the light of modern jurisprudence and portfolio theory. This rule, whose roots in American legal history reach back to the early nineteenth century, provides guideposts for professional managers responsible for optimally investing the holdings of charities and other tax-exempt entities.

The prudent investor rule was originally stated in Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830). The relevant language reads:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested. 26 Mass. (9 Pick.) at 461.

Nothing in that language restricts the sorts of investments a prudent trustee might make. Over time, however, courts and scholars (most notably Austin Wakeman Scott in his treatise and

the RESTATEMENT OF TRUSTS) interpreted the rule restrictively, limiting charitable trustees to specific low-risk investments, such as government or mortgage-backed securities. Many states limited charities' investments in common stock until the 1940's. See Gordon, The Puzzling Survival of the Constrained Prudent Man Rule, APPENDIX B, B. LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 195 (1986), later republished in substantially identical form as Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52 (1987). See also Haskell, The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory. 69 N.C. L. Rev. 87 (1990).

The conservatism bred by the narrow interpretation of the prudent investor rule in early 1900's may well be partially responsible for the poor management of many endowments, excepting perhaps only the very largest. A recent study of the investment performance of foundations concludes:

> While the overall rate of return on foundation assets exceeded the market averages, this was primarily because of the performance of the relative handful of larger foundations. In contrast, most foundations performed below the control portfolio. In fact, the rate of return the median foundation achieved was not sufficient to support a minimum 5-percent payout rate and still preserve the real, inflation-adjusted value of the asset base. . . . In addition, only a fraction of the foundation universe made use of an active investment management approach. . . .
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> Investment management for a significant portion of the foundations consisted of turning the assets over to outside managers to be invested in low-risk, fixed-income securities. L. SALAMON & K. VOYTEK, MANAGING FOUNDATION ASSETS: AN ANALYSIS OF FOUNDATION INVESTMENT AND PAYOUT PROCEDURES AND PERFORMANCE 53-54 (1989).

In general, the Code and Regulations have responded ambivalently to the apparent over-caution generated by the prudent investor rule. Regulations under § 4944 governing

investments that jeopardize a private foundation's charitable purpose are particularly difficult to parse. On the one hand, they call for close scrutiny of "[t]rading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts' and 'calls', and 'straddles,' the purchase of warrants, and selling short." Reg. § 53.4944-1(a)(2)(i). Adopted in 1972, this language reflects the then-prevailing tendency to measure prudence on an investment-by-investment basis. On the other hand, the same regulation also provides that "[t]he determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's Portfolio as a whole." Id. (emphasis added). In our view, the Service should open a regulations project to cure this inconsistency and to bring Reg. § 53.4944-1(a)(2)(i) into line with modern investment theory's focus on the overall performance of the foundation's portfolio.

By contrast, the ERISA regulations look explicitly to the overall performance of the trustee's investments. These rules allow a trustee to make

> a determination . . . that the particular investment or investment course of action is reasonably designed, as part of the portfolio ... to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action. ..." 29 C. F.R. § 2550.404a-1(b)(2) (emphasis added).

This approach is consistent with modern portfolio theory, which has been described as follows:

> The key to this approach is process. Prudence is to be found principally in the process by which

> investment strategies are developed, adopted, implemented, and monitored in light of the purposes for which funds are held, invested, and deployed. Prudence is demonstrated by the process through which risk is managed, rather than by the definition of specific risks that are imprudent. B. LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 7 (1986).

Longstreth urged the American Law Institute to reconsider the prudent investor rule. The ALI did so, and the resulting revision was approved in 1990. It is due to be published within the next two months. The penultimate draft rejects the constrained prudent investor rule in favor of an approach reflecting modern portfolio theory. FINAL DRAFT, RESTATEMENT OF THE LAW, TRUSTS § 227(a) (April 6, 1990) (stating that the prudent investor standard “is to be applied to investments not in isolation but in the context of the trust portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust”).

The use of swap techniques, hedging transactions, or comparable investment strategies is fully consistent with recent developments in portfolio management theory and with the evolution of rules governing prudent investment by fiduciaries. While a single such investment transaction, taken by itself, may be somewhat speculative, these transactions generally may enhance the prudence of a tax-exempt's investments, particularly when they are undertaken, with sophisticated investment advice, as part of a comprehensive portfolio management strategy. It is reasonable, therefore, to expect that tax-exempts will increasingly employ portfolio management techniques, such as interest rate and currency swaps, as part of their ongoing investment management techniques. Such strategies should properly be seen not as a new business of the tax-exempt, but merely as a

more sophisticated version of what tax-exempts have traditionally done in managing their investments.

We appreciate the Service's possible concern with the difficulty of administering a rule that flexibly permits tax-exempt organizations to engage in a growing range of sophisticated investment strategies. We are sympathetic with the limits on IRS resources and the difficulty of understanding and auditing complex investments and financial instruments. On balance, however, we believe that it would be unwise to freeze tax-exempts into more simple investment opportunities. That would be inconsistent with the development of the law outside of the Code, and would leave tax-exempts at a disadvantage with respect to other investors.

V. Conclusion

It seems incontrovertible that tax-exempt entities should not be precluded from employing modern portfolio theory by a lack of clarity in the UBIT rules or by an imposition of the UBIT on investments that do not unfairly benefit tax-exempts. In the past, as tax-exempts have undertaken investments unknown or uncommon when the UBIT was enacted, Congress responded with statutory amendments expressly exempting these “new” investments from the UBIT. This approach has prevented unnecessary confusion and over-caution on the part of tax-exempts concerned about falling afoul of the UBIT rules. Interest rate swaps and other developing portfolio investments are as consistent with tax exemption as are the other investment activities Congress has exempted from the UBIT. A regulatory or statutory clarification excluding from the UBIT non-dealer income derived in connection with securities and other financial products would remove

unnecessary tax obstacles to optimal investments without undermining the goals underlying the UBIT rules.