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August 12, 2010

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Washington, DC 20220

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Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: <u>Section 514: Debt-Financed Income Subject to UBIT</u>

Gentlemen:

We are pleased to submit New York State Bar Association Tax Section Report No. 1217, concerning Internal Revenue Code Section 514 and the imposition of the unrelated business income tax ("UBIT") on the debt-financed income of tax-exempt organizations.

The broad-based debt-financed income rules of Section 514 were enacted as part of the Tax Reform Act of 1969. The Section 514 rules generally subject otherwise tax-exempt investment income (including

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interest, dividends, rents, royalties and capital gains) to UBIT if the investment property is subject to acquisition indebtedness. In the early 1980s, Congress created exceptions to Section 514 for pension plans and schools that invest in debt-financed real estate. In recent years, several proposals have come before Congress to exclude from the Section 514 UBIT rules partnership income allocated to tax-exempt organizations where the income is attributable to debt-financed investments in securities and commodities held by the partnership itself.

The report recommends that Congress, together with Treasury, undertake a ground-up review of Section 514 in light of the over 40 years of experience with the rules, changes in circumstances occasioned by other statutory and regulatory tax provisions, changes in institutional investment practices, and changes in the global investment environment. The report suggests that Congress and Treasury consider the extent to which appropriate tax policy goals are being furthered by the debt-financed income rules, and the various exceptions to those rules, in their current form.

The report requests Congress to consider the fundamental tax policy question of whether it is appropriate to apply UBIT to any or all routine investments made by tax exempts where some form of leverage is utilized. In particular, we question whether UBIT should apply to debt-financed income from securities and commodities. One might similarly ask whether exemptions in certain sectors (e.g., real estate) but not others creates distortions in the allocation of investment resources. Are the distinctions between organizations eligible for exemption from UBIT on debt-financed real estate, generally pension plans and schools, and those not so eligible, including public charities, private foundations and churches, warranted? Would safeguards be needed (e.g., in connection with partnerships) to avoid abusive transactions if Section 514 were scaled back or repealed?

At the same time, we note that Section 514 often can be avoided by structures or transactions that essentially are economically equivalent to transactions taxed under Section 514. The ability to structure around Section 514 places a premium on tax planning and raises fairness issues for organizations not large enough or sophisticated enough to engage in such planning. If, following a review of Section 514, Congress were to determine to maintain the debt-financed income rules in whole or in part, because of revenue concerns or policy considerations, then we would suggest consideration of whether changes might be appropriate to clarify the extent to which the rules apply to structures and transactions that either have limited economic substance or otherwise essentially are economically equivalent to structures and transactions which are taxable.

The report discusses only the debt-financed income rules of Section 514. It does not address or question the ongoing importance of the UBIT rules generally (Sections 511-513).

We appreciate your consideration of the enclosed report. Please let us know if you would like to discuss these matters or if we can assist you in any other way.

Respectfully submitted,

Peter H. Blessing
Chair

Enclosure

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