REPORT
JULY 8, 2011

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TAX GROUP REPORT

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LOSSES AND DEDUCTIONS FROM A TAX-EXEMPT ORGANIZATION'S UNRELATED TRADE OR BUSINESS – MAXIMIZING TAX EFFICIENCIES IN A DISTRESSED REAL ESTATE MARKET

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In connection with its ongoing compliance audits of colleges and universities, the Internal Revenue Service has been reviewing the extent to which colleges, universities and certain other Code Sec. 501(c)(3) organizations reported tax losses from unrelated businesses. According to news reports, the IRS believes that these losses have been used to offset taxable income realized by the organizations from unrelated trades or businesses, i.e., income from activities not related to their tax-exempt functions, such as income from leveraged portfolio investments. Although tax-exempt entities ordinarily are not subject to income tax, those organizations are taxable on their net income from an unrelated trade or business. Thus, losses from an unrelated trade or business can be used to shelter taxable income from an unrelated trade or business in determining the organization's net taxable income.

The IRS circulated a compliance questionnaire to approximately 400 colleges and universities in 2008. That questionnaire required specific and detailed information concerning, among other things, the ownership by tax-exempt organizations of "disregarded entities", related tax-exempt organizations, and related entities taxable as partnerships, corporations and trusts. The compliance questionnaire also required the tax-exempt organization to identify if it was a "controlling organization" with respect to an entity within the meaning of Code Sec. 512(b)(13) and, if so, the number of entities controlled by it[1]. The questionnaire asked very detailed information about activities engaged in by these organizations including, for example, whether the entity directly operated a parking lot, a catering service, or a golf course, and, if so, how the organization accounted for the gross income under the rules relating to unrelated business taxable income. The clear purpose of this questionnaire was to develop information from the tax-exempt organizations about the nature and extent of their unrelated business activities.

Following up the compliance questionnaires, the IRS has been auditing some of the colleges and universities. In particular, commentators have noted that the IRS appears to be focused on certain unrelated business activities engaged in by those entities where the activities have a history of producing losses used to offset income from profitable, unrelated business activities.

On at least one level, the IRS's focus on loss-producing activities of tax-exempt organizations is a rational exercise of its examination powers. To the extent that the tax-exempt institution engages in an activity without the requisite profit motive, but with an intention to produce taxable losses that can be used to shelter its otherwise taxable income, the IRS has an interest in determining whether the deduction for those losses can be sustained for tax purposes. The IRS likely believes the tax-exempt institution is in precisely the same position as taxable investors that made tax-motivated investments with a likelihood of producing substantial tax losses and a low likelihood of producing net economic income in order to shelter their taxable income. The use by taxpayers of those, and other, tax-motivated strategies was among the reasons for the enactment in 2010 of the Code Sec. 7701(o) "economic substance" rules.

The attention given by the IRS to activities generating losses from unrelated trade or business activities should not detract from the opportunities which may exist for tax-exempt institutions to harvest taxable losses from their existing investment portfolios, particularly those institutions that invested in alternative equity investments. To the

1 The income tax return required for tax-exempt entities, Form 990, now requires that the tax-exempt entity list on Schedule R entities that are related to the tax-exempt entity, including all disregarded entities and partnerships and corporations controlled by the tax-exempt entity.

extent that tax-exempt institutions can generate unrelated business taxable losses that might otherwise have been overlooked, or perhaps reclassify an investment loss so that it is a loss from an unrelated business, the losses may be used by these institutions to offset income from unrelated trades or businesses. These losses may be particularly useful in sheltering taxable income from alternative equity investments which is often taxable as unrelated business income. Income from alternative investments can be unrelated business income because the tax-exempt investor is treated as having incurred indebtedness to acquire the underlying portfolio investment[2]. Where the tax-exempt entity's investment resulted in a real economic loss, the use of that loss to offset taxable income or gain at least provides some tax benefit from the loss.

In particular, tax-exempt organizations may have significant unrealized losses which they assumed would not be from an unrelated trade or business and, therefore, would be unavailable to offset their taxable income. That assumption may be misplaced, and more effective management of their unrealized losses could result in securing taxable losses with a commensurate tax benefit. This is particularly true were the tax-exempt organization invested in leveraged real estate through a structure designed so that the expected income would not be taxable.

I. Restructured Leveraged Real Estate Investments That Fail the So-Called "Fractions Rule" After the Restructuring.

The following is an example of a relatively common case where, with some careful planning, a tax-exempt investor might be able to take steps to restructure its investment in a leveraged real estate asset and generate a loss from an unrelated trade or business that would be usable to offset its unrelated business taxable income.

It starts with an investment in a real estate joint venture where the original investment was structured so that the income from the joint venture would not be taxable as unrelated business income. To meet this objective, the joint venture agreement met all of the conditions for compliance with the so-called fractions rule[3] including the requirement that the joint venture's liquidating distributions be made in accordance with ending capital account balances.

> ***Example (1)***: Three years ago, a tax-exempt organization ("TO") entered into a joint venture to acquire and operate a suburban office building with a local real estate developer. The acquisition of the property was financed with equity provided by TO and a non-recourse mortgage loan provided by a bank and secured by the real property. The acquisition of the property and the financing met the conditions for the safe harbor of Code Sec. 514(c)(9) so that the indebtedness incurred by the JV in acquiring the building was not "acquisition indebtedness" as to TO. Therefore, the real property did not constitute "debt-financed property", the income from which would be taxable unrelated business income in the hands of TO. The developer was entitled to a "profits interest" under the JV Agreement. The value of the property has diminished significantly and the mortgage loan is now in default. At this point, the adjusted income tax basis of the property is $50 million, the estimated value of the property is $41 million, and the outstanding indebtedness secured by the property is $40 million. If the property were sold for its estimated value, TO would report a loss of approximately $9.0 million, no part of which would be deductible as a loss from an unrelated trade or business, because the investment was expected to be profitable, and the JV was structured so that the income (or loss) from the investment would not be debt-financed income (or a debt-financed loss).

The unrealized loss in Example (1), which is a real economic loss and not an artificial tax-shelter loss, could not be used to offset taxable unrelated business income which the tax-exempt entity might be earning from other investments.

Because of the changed economic conditions and contrary to its initial investment objectives, TO now is focused solely on maximizing the recovery of its initial investment and does not reasonably expect to recognize a net economic profit from

2 See, e.g., Horton Bartels Trust ex rel. Cornell Univ. v. United States, 613 F. 3d 1357 (Fed. Cir. Sept. 7, 2010) (In a case dealing with income from a portfolio of securities financed, in part, with margin debt, the Federal Circuit held that it was irrelevant whether the Trust's investments in securities satisfied the definition of an "unrelated trade or business" under Code Sec. 513 because separate provisions—Code Secs. 512(b)(4) and 514—explicitly classified income from debt-financed property as income from an unrelated trade or business.)

3 Compliance with Code Sec. 514(c)(9)(E) (the "fractions rule") requires, among other things, that the tax-exempt entity's share of overall partnership income not exceed its share of overall partnership loss and that distribution in liquidation be made be made with accordance with ending capital accounts.

its investment in the property. On these facts and with some careful planning, there might be an opportunity to convert TO's non-taxable loss into a loss from an unrelated business that could be used to offset otherwise taxable income or gain. Suppose that, in connection with a restructuring of the JV's debt and infusion of additional equity (to carry the property) by a taxable investor, e.g., the developer, the cash distribution waterfall was restructured so that the new equity ($1 million) was given a distribution priority over the agreed value of TO's existing capital (valued at approximately $1 million). After the repayment of the agreed equity values, the remaining cash would be split 50:50. As part of the cash infusion, the partners also agreed that distributions in liquidation would not longer be made in accordance with ending capital account balances and would, instead, follow the cash waterfall in all cases. The JV agreement would now fail the Code Sec. 514(c)(9)(E) fractions rule so that the income *or loss* from the property would now be income or loss from a debt-financed asset. As a result, some substantial portion of the income or loss would be treated as income or loss from an unrelated trade or business.

Subsequent to the restructuring, assume the property was sold for $44 million. Following repayment of the $40 million loan secured by the property, $2 million would be distributable to the holder of new equity and $2 million to TO. The JV would report a book gain of $2 million, 50 percent of which would be allocable to the taxable investor, and an $8 million taxable loss allocable solely to TO, $6.4 million of which would be a loss from an unrelated trade or business[4]. That unrelated business loss would then be available to shelter income earned by the tax-exempt organization from another unrelated trade or business. If that other income were otherwise taxable at a 35 percent tax rate, the value of the loss to the organization would be approximately $2.25 million, or more than its actual cash recovery from the sale.

Example (1) describes one tax planning opportunity available to some tax-exempt investors in today's distressed real estate environment. It is an opportunity that could be available where the real property was acquired through a leveraged joint venture in the expectation that the property would appreciate significantly in value and would be sold for a substantial economic gain. The partnership or joint venture agreement followed the detailed set of rules for tax-exempt investors that qualified for the special exception to the debt-financed income rules for leveraged real estate investments that required, among other things, liquidating distributions be made by ending capital account balances. These agreements were structured to meet the strictures of the so-called fractions rule of Code Sec. 514(c)(9). It is a truth universally acknowledged by tax practitioners in this area that compliance with the so-called fractions rule of Code Sec. 514(c)(9) can be extremely difficult. Example (1) illustrates one case where, as a result of restructuring the partnership to conform to a real world, arms-length economic arrangement, the allocations under the JV Agreement cease to meet the requirements of the fractions rule. Under the Treasury Regulations, the change in the partnership allocations is taken into account in determining whether the partnership satisfies the fractions rule in the taxable year of the change and in subsequent taxable years. Treas. Reg. §1.541(c)-2(k)(1). Therefore, after the change in the agreement, the property is debt-financed property as to TO and any loss would be a loss from an unrelated trade or business.

The key point to recognize is that the change in the allocations under the partnership agreement which results in the failure of the allocations under the revised partnership agreement to satisfy the fractions rule *does not result in a taxable disposition of the tax-exempt partner's interest in the partnership*. Absent some taxable disposition of its interest or of the real property, the tax-exempt partner continues to own its proportionate share of the partnership with the same, undiminished, built-in loss with respect to the assets of the partnership. That loss, if recognized in a taxable year following the change in the partnership agreement, is automatically qualified as a loss from an unrelated trade or business, however.

II. What Are the Consequences of Adopting the Example (1) Strategy Within a Multi-Property Real Estate Fund?

The fractions rule does not apply on a property-by-property basis, as is the case with the other Code rules dealing with debt-financed income. Instead, the fractions rule applies to the overall income and overall losses of the partnership. Recent comments by Section of Taxation of the American Bar Association[5] point out a potential issue in the Treasury

4 The calculation of the amount of the loss allocable to TO, and the portion of that loss which is a loss from an unrelated trade or business, is a function of two different Code provisions: (i) the convention adopted by the JV to account for the reverse-Code Sec. 704(c) allocation of the built-in loss to TO and (ii) the fraction represented by the outstanding balance of the mortgage loan over the adjusted tax basis of the property.

5 ABA (Tax Section), Comments Concerning Partnership Allocations Permitted Under Section 514(c)(9)(E), Section VIII (January 19, 2010). Joshua C. Weinberger, a member of the Cozen O'Connor Tax Practice Group, was one of the authors of these Comments.

Regulations under Code Sec. 514(c). The comments raise the issue whether, in a typical fund arrangement, i.e., a holding partnership with each of the fund's separate real estate investments owned in a stand-alone, lower-tier entity that is not a disregarded entity, a single investment in a lower-tier partnership that is not, or ceases to be, fractions rule compliant may jeopardize fractions rule compliance with respect to the entire fund. It is beyond the scope of this paper to analyze whether the non-compliance of a lower-tier partnership would or should call into question the fractions rule compliance of the upper tier entity (and all of the other lower-tier entities as well). Nevertheless, this is an issue that needs to be considered if the strategy described in Example (1) were employed by a fund owning interests in multiple lower-tier entities

III. How a Change in the Purpose for Which an Asset Was Held at the Time of Sale Can Alter the Character of the Loss.

Example (1) involved a change in the allocation and distribution provisions of the partnership agreement which lead to a failure to comply with the requirements of the fractions rule, causing the property owned by the JV to produce a loss from debt-financed property. Example (2) is a case in which the partnership's method of operation and intention with respect to the property changes so that the loss allocable to the tax-exempt organization from the partnership can be treated as an ordinary loss from an unrelated trade or business.

> ***Example (2)*:** A real estate fund (the "Fund") was formed several years ago to purchase holdings of undeveloped real estate in the Northwestern United States. The business plan for the Fund was to acquire significant tracts of land, unleveraged, and hold the land for disposition to developers. The sales were to be carried out so that the Fund would not be a "dealer" with respect to the sales of the land. The gain would be reported as capital gain income so that taxable investors could report long-term capital gain from the sale of the land and tax-exempt investors could avoid reporting any portion of the gain as being from an unrelated trade or business[6]. The Fund invested $50 million in the land and now owns approximately 10,000 acres of land in which it has an adjusted income tax basis of $50 million. The Fund estimates that the fair market value of its land is now approximately $20 million. Under its organizational documents, the Fund has a finite life and generally is required to commence the orderly liquidation of its assets not later than 2014.

In accordance with its original investment plan, the Fund would be expected to liquidate its assets so that the property sold would not be treated as dealer property in the hands of the Fund. This typically involves disposing of the properties by way of only a few large sales, a minimum of intensive sales activity, and the least amount of site work and subdivision activity. The losses resulting from such sales (at the current fair market value) would be capital losses for the taxable investors and would not be losses from an unrelated business (available to offset taxable income) for tax-exempt investors.

The Fund may want to consider an alternative plan for disposing of its land holdings, however. It has an approximately $30 million built-in loss with respect to its assets at this point in time. If the Fund does not believe that there will be a significant net growth in the value of the land (above its original investment) before it sells the land, the Fund may want to consider disposing of the property in a way that causes the Fund to be treated as a "dealer" with respect to the land. For example, it could undertake active subdivision and land permitting activities or engage developers to perform such services for its benefit. In furtherance of its dealer activity, it could contribute the land to a joint venture with a developer who has those capabilities and access to financing for the development costs.[7] Or the Fund could undertake an intensive sales campaign, with widespread advertising and multiple property sales, to dispose of the land. The new disposition plan would evidence an intention to hold the land for sale rather than solely for investment[8] at the time the losses were recognized. This change in its intention with respect to the land could convert the built-in loss from a capital loss to an ordinary loss. More importantly, the tax-exempt investors could report the

6 Under Code Sec. 512(b)(5), gains and losses from the sale or exchange of non-dealer, unleveraged real property generally are excluded from taxation as unrelated business income.

7 The contribution can occur only after the Fund establishes that the land is dealer property. Otherwise, the joint venture losses from the disposition of the land would be a capital loss. Code Sec. 724(c) taints the loss from the disposition of contributed assets with built-in capital losses for 5 years following the contribution.

8 Under the case law and the position of the IRS, it is the intention of the taxpayer at the time of the sale which determines whether property was held for sale to customers, i.e., dealer property, or held for investment. See e.g., Donald R. Cottle, 89 T.C. 467, 487 (1987).

loss as a loss from an unrelated trade or business. That loss would then be available, 100%, to offset income from other unrelated trades or businesses. To the extent that the tax-exempt entity did not have income from an unrelated trade or business in the years in which the losses were recognized, the losses can be carried back and carried forward under the normal Code loss carryover rules, i.e., generally back to each of the two taxable years preceding the year of the loss, and forward to each of the succeeding 20 years. The losses would then available to offset unrelated business income of the organization in those years. In the case of the Fund, the law is clear that the change in intention with respect to the land is not a taxable disposition of the land. Moreover, the tax planning goals of the tax-exempt and taxable investors would be the same, i.e., to cause the losses to be treated as losses from dealer property in order to improve their tax efficiency..

IV. Conclusion.

The two cases illustrated above demonstrate how tax-exempt entities may be able to aggressively manage the disposition of parts of their distressed real estate portfolios with a view to creating losses from unrelated trades or businesses. Those losses, which represent real economic losses, could then be used to offset income from unrelated trades or businesses such as income from debt-financed portfolio investments.

Although the results in the Examples illustrated above may appear to be anomalous, they follow from the application of the relevant Code provisions. In neither case does the Code treat the change in the status of the property as a taxable disposition of the property. In fact, the opposite treatment is called for under the Code, i.e., no taxable disposition in the absence of a statutory recognition event. Absent a taxable disposition, there is no adjustment in the tax basis of the property to its current fair market value, whether upward or downward. It is likely that any attempt to challenge these results would fail because of the absence of any statutory authority permitting the change in the asset basis. In a somewhat similar circumstance more than 10 years ago, the IRS exercised special regulatory authority given it under Code Sec. 337 to provide, in a case where a taxable corporation transferred all or substantially all of its assets to one or more tax-exempt entities in what would otherwise have been a tax-free transaction, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market values. Treas. Reg. § 1.337(d)-4(a). This "change-in-status" taxable disposition rule was viewed by the IRS as necessary to carry out the purposes of General Utilities repeal, including the specific grant of authority to write rules to ensure that the General Utilities repeal not be circumvented through the use of a tax-exempt entity. In the cases examined above, there is no transfer of assets between taxable and tax-exempt entities and no corporations are involved so that the transactions should be beyond the reach of the broad grant of authority under the General Utilities repeal legislation.

The attorneys at Cozen O'Connor have experience in dealing with all of the tax issues involved in structuring investments by tax-exempt entities in typical investment vehicles as well as in real estate and alternative equity investments. If you would like to discuss the impact of the Internal Revenue Code rules relating to the taxation of an exempt organization's income and loss from unrelated trades or businesses, please contact any of the attorneys in our Tax Group listed below.

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