COUNCIL on FOUNDATIONS

LEGAL COMPENDIUM FOR COMMUNITY FOUNDATIONS

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CHAPTER 5, Issues Posed by Certain Types of Property

This is an excerpt from the *Legal Compendium for Community Foundations* (Council on Foundations, 1996).

Note that while much of the information in the following excerpt is still accurate and relevant, some changes in the law and regulations may affect portions of this material. For this reason, this material should be read in conjunction with other, more recent resources, or should be used in consultation with local counsel who can advise on any changes.

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Issues Posed by Certain Types of Property

A. General Concerns

There are generally three concerns that the directors or trustees of a community foundation have when they contemplate whether to accept a charitable contribution. The first is whether the community foundation is willing and able to carry out the donor's objectives.[432] The second is whether there is a material restriction associated with the contribution that could make the fund a non-component fund.[433] The third occurs when the contribution consists of property other than cash: Is it in the community foundation's best interests to accept such property or are there material restrictions or other significant liabilities associated with the property so that the community foundation should decline the contribution? This chapter will examine the pitfalls and benefits from contributions of property.

1. INVESTMENT RETURN AND MARKETABILITY

From a community foundation's perspective, the most important issues concerning a contribution of property are the investment return from the property, its marketability and any actual or potential liabilities (including liability for the unrelated business income tax) associated with the property. These concerns are consistent with state fiduciary laws and with federal tax requirements imposed on community foundations that require financial resources to be prudently invested. Every community foundation receives inquiries from potential donors who are interested in contributing hard-to-sell real estate or stock in a closely-held business that has little economic value. Community foundations should not be a dumping ground for junk, particularly junk that even the owner has been unable to sell through his or her own efforts.

A community foundation should have flexible policies concerning the type of property it will accept or reject. One guideline would be to reject property if it does not reasonably appear that the property can be converted into income-producing assets within a specific time frame, such as three to five years. This is particularly important for property held in designated funds.[434] Exceptions could be made for non-productive assets that

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[432] For example, some community foundations have established policies that they will not accept gifts for religious purposes.

[433] See Section THREE.A of this publication for the law governing material restrictions, and Sections THREE.C.4 through THREE.C.7 for a list of material restrictions that are associated with contributions of property (land, stock, etc.).

[434] The tax regulations require the governing body of a community foundation to commit itself to seeing that each trustee, custodian or agent produces a reasonable return of net income. Whereas the assessment is made based on the aggregate performance of most funds, the assessment is made on a fund-by-fund basis for those funds that benefit five or fewer charitable organizations (i.e., designated funds). Treas. Reg. Sections 1.170A-9(e) (11) (v) (F) and 1.170A-9(e) (13) (x).

further a charitable purpose, such as a woodland preserve[435] or a program-related investment.[436]

If someone anticipates making a bequest of property to a community foundation, it would be advisable to first obtain the consent of the community foundation to accept the property before the will is drafted. Since the individual is probably expecting a large estate tax charitable contribution deduction, there could be problems if, after the death of the donor, the community foundation first learns of the bequest and rejects the property as unsuitable.

2. LIABILITIES ASSOCIATED WITH THE PROPERTY

a. General Policy Considerations

Marketable stock, the most common form of property contributed to community foundations, does not pose any significant costs or burdens. However, other forms of property that are likely to be offered to a community foundation, such as real estate, partnership interests and even stock in a closely-held business, do pose potential hazards. There is always a temptation, particularly among newly established community foundations, to accept any type of contribution, but this must be tempered by the costs and liabilities the asset could bring.

A community foundation could reach an understanding with a donor who contributes property to establish a fund that the costs associated with the property will be charged to that fund. There should also be an understanding that the donor will contribute sufficient cash to the fund to cover maintenance costs. Prudence dictates that if the property could have contingent liabilities, such as environmental cleanup costs, then the donor should warrant that the property is free from such liabilities and will agree to pay such costs if they arise in the future. In some cases, it would be appropriate to incur investigative costs (such as surveys or sampling for environmental contamination[437]), preferably at the donor's expense, before accepting the property.

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[435] Treas. Reg. 1.307-2 (a) (8) (iii) (D). The IRS concluded that a major league baseball team that was given to a community foundation also constituted a charitable asset. Private Letter Rulings 9330024 through 9530026.

[436] A program-related investment (PRI) is a loan, purchase of stock or some other form of investment made primarily for charitable purposes rather than for the production of income. From a programming perspective, a PRI is most suitable for a project that traditionally requires a loan or capital investment (e.g., a construction project or a scholarship loan). Usually the investment is made under terms that would be unacceptable to a commercial lender or investor. For example, a loan might bear a below-market interest rate or a stock investment might have a very high risk of failure. One IRS private letter ruling involved the purchase by a field of interest fund of 22% of the stock of a bank holding company that owned a minority-owned bank. Private Letter Ruling 9134033 (May 31, 1991).

Technically, a PRI is an investment that meets a definition that is only applicable to private foundations. Code Section 4944(c); Treas. Reg. Sections 53.4942(a)-3(a) (2) and 53.4942(a)-2(d) (4) (i). As a public charity, the charitable investments of a community foundation do not have to meet the definition of a PRI. Instead, a public charity is subject to general fiduciary standards of reasonable investments and to a general duty to operate for charitable purposes.

[437] See footnote 444 and the accompanying text for a summary of Phase One, Phase Two, and Phase Three environmental audits.

One way a community foundation might be able to reduce, but not eliminate, the risk that an asset could pose is to have the contribution made to a separate corporation or trust rather than directly to the community foundation.[438] This could limit the legal exposure from liabilities produced by the asset to the resources in the corporation or trust, thereby leaving the community foundation's other assets unaffected. A few community foundations have established separate organizations to receive gifts of real estate (described below).

A similar strategy may be appropriate for philanthropic funds that may engage in activities that could generate liabilities. For example, a group may establish a scholarship fund at a community foundation and then might conduct bake sales, golf tournaments, carnivals or other fund-raising events that could generate liabilities. A charity can be liable for injuries that occur at these activities and even for the car accidents of volunteers who are on their way to a charitable function.[439]

A community foundation that holds millions of dollars of investment assets should consider adopting policies that will protect these assets from such claims. One policy would be to prohibit such fund-raising events. If a community foundation will allow such activities, it can purchase insurance for each event. Finally, it may be advantageous for such a fund to be a separate corporation and be classified as a supporting organization rather than a component fund. This could make it more difficult for a creditor to pursue the assets of a community foundation, but it would not be impossible.[440]

b. Identifying Costs and Liabilities

i. In General

The costs associated with property are generally (1) carrying costs, (2) existing liabilities and contracts, (3) contingent liabilities and (4) the unrelated business income tax.

If the carrying costs (insurance, taxes, etc.) associated with an asset are significant, a community foundation should consider declining the contribution. For example, the costs of maintaining dilapidated rental properties, and the expenditures necessary to rehabilitate such properties for resale, could constitute a net drain on a foundation's resources if the donor is not willing to assume them.

A donor might ask a community foundation to assume a debt, contract or lease as a condition of receiving the property or to take the property subject to such an obligation.

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[438] A corporation might be a more appropriate entity for this purpose than a trust. State laws often impose fiduciary duties on trusts to hold diversified investments and to avoid holding risky property.

[439] "Liability of Charitable Organization Under Respondent Superior Doctrine for Tort of Unpaid Volunteer," 82 A.L.R. 3d 1213; "Tort Immunity of Non-governmental Charities-Modern Status," 25 A.L.R 4th 517.

[440] See, for example, *Sokolow v. City of Hope*, 262 P 2d 841 (Cal 1953) where a hospital was held liable for an injury to a volunteer who was injured at a fund-raising event sponsored by the hospital's supporting organization. See infra n. 449 and the accompanying text for the legal argument of "piercing the corporate veil."

Such an arrangement could pose several hazards. First, it could be a drain on the foundation's cash until the property is sold. Second, the presence of debt might make the property "debt-financed property" that would make the community foundation liable for unrelated business income tax (UBIT) on a portion of the income produced by the property.[441] Third, such action could be a material restriction that could make all or part of the fund a non-component fund[442] Finally, the donor could be subject to income tax from the transaction since a charity's assumption of a debt is usually treated as a "bargain sale" under the tax laws.[443]

ii. Real Estate

Real estate is a classic example of property that has carrying costs (insurance, maintenance, taxes, etc.). It is sometimes encumbered by debt and it may be difficult to sell. Consequently, a community foundation should take some of the precautions that are mentioned in the preceding paragraphs before accepting the gift.

A significant risk associated with land today is the potentially horrendous environmental cleanup costs. For example, did the property ever have underground storage tanks that may have leaked? It is very common for purchasers, lenders and even charities to insist on a Phase One audit (typically costing between $2,000 and $3,000) before acquiring property.[444] For example, before it accepted a bequest of a farm, the Milwaukee Foundation found chemicals on the property that had to be shipped to Finland for disposal. Several lawsuits have attempted to impose cleanup liability upon charitable organizations and banks that have acquired property by way of contribution[445] or foreclosure on a mortgage.[446]

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[441] See Section FIVE.B.2 for the rules governing debt-financed property.

[442] See Section FIVE.A.3 below for a list of actions that can constitute material restrictions with respect to contributed property.

[443] Treas. Reg. Section 1.1011-2(a) (3), *Guest v. Commissioner*, 77 T.C. 9 (1981). See also Section SIX.C.2.c for the general rules concerning bargain sales.

[444] A Phase One audit typically involves a site visit, an examination of land and permit records, interviews with prior users and limited sampling of soil, water and air quality. If the Phase One audit raises concerns, the examination can move to a Phase Two audit (extensive sampling and testing) with costs of $10,000 or more. Phase Three involves the cleanup.

[445] Goodwill Industries of Chicago and Cook County is in the unenviable position of suing a paint-manufacturing corporation and a director of the corporation who contributed an eight acre paint factory to it in 1984. The Illinois EPA discovered large concentrations of lead, asbestos and toxic solvents on the property. Because Goodwill is the owner, it may be liable for the multi-million dollar cleanup costs. The organization has already invested nearly S1,000,000 in the property which is virtually unmarketable because of the environmental contamination. "Clearing the Air on New Law; Today's Environment Even Baffles Attorneys," *Chicago Tribune*, Real Estate Section, p. 1 (Feb. 11, 1990).

[446] Some banks are waiving their right to foreclose on contaminated property in order to avoid direct liability for cleanup costs. "Bank Board Issues Thrift Bulletin Giving S & Ls Guidance on Environmental Liability," Vol. 52 *BNA s Banking Report* (No. 14) p. 782 (Apt. 1989). A similar strategy could be appropriate for a community foundation that holds a mortgage on such property. See *also U.S. v. Fleet Factors Corp*., 901 F.2d 1550, at 1558 (11th Cir. 1990), where the Eleventh Circuit Court of Appeals concluded that a lender or other organization can be liable for environmental cleanup costs if it has sufficient involvement with a facility "that it could affect hazardous waste disposal decisions if it so chose."

Several community foundations have attempted to reduce the potential risks posed by real estate by holding all contributed real estate in a separate corporation or trust. Sometimes the separate entity is classified as a "supporting organization" rather than a component fund.[447]

The principal advantage of such a strategy is that it helps to isolate the administrative burdens and the risks posed by real estate. The liabilities associated with real estate may be limited to the assets of that corporation or trust, which can protect the other resources of the community foundation. Another advantage is that it separates the investment return of real estate investments from other investments.[448]

Although a separate legal status makes it more difficult for a creditor of that corporation or trust to reach the other assets of a community foundation, it does not guarantee protection. On relatively rare occasions the courts have held that a party who unfairly controls a corporation can be personally liable for the corporation's debts. Usually a plaintiff has to demonstrate fraud to "pierce the corporate veil."[449] However, some courts have concluded that control alone, even without fraud, can make a controlling party liable for environmental cleanup costs.[450]

As a general rule, a trustee of a trust will not incur personal liability for debts associated with the property held in a trust. Instead, the property available to satisfy the claims of creditors of the trust will generally be limited to the assets of the trust. There are exceptions to this principle which are analogous to piecing the corporate veil, described above. In addition, a trustee of a trust, including a charitable remainder trust, can be personally liable for environmental cleanup costs under certain circumstances. One court held that a trustee who had the power to control the use of trust property and who knowingly allowed the property to be used for the disposal of hazardous wastes was

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[447] Corporations and trusts can be component funds under Treas. Reg. Section 1.170A-9 (e) (11) (ii) (analyzed in Section THREE.A). A supporting organization is a separate legal entity that is organized and operated exclusively for the benefit of a publicly supported charity, such as a community foundation. Section 509(a) (3). See Chapter EIGHT of this publication for more information about supporting organizations.

[448] The asset balances for philanthropic funds that were established with contributions of cash and marketable securities could then reflect the investment return produced by those investments whereas funds established with contributions of real estate would reflect their investment returns. This may produce a fairer result than commingling such different types of investments.

[449] See "Stockholder's Personal Conduct of Operations or Management of Assets As Factor Justifying Disregard of Corporate Entity," 46 A.L.R.3d 428; "Liability of Corporation for Contracts of Subsidiary," 38 A.L.R.3d 1102; and "Liability of Corporation for Torts of Subsidiary," 7 A.L.R.3d 1343.

[450] See, for example, U.S. v. Kaiser-Roth Corp., 724 F.Supp 15 (1989) in which a corporation that held 100% of the stock of an insolvent corporation that operated a textile mill was held liable for environmental clean-up costs because of its ownership and control of the subsidiary. The court concluded that the parent corporation had the power to control how the subsidiary's waste would be disposed. A mortgage holder can also be liable even without a foreclosure. The Eleventh Circuit Court of Appeals concluded that a lender or other organization can be liable for environmental cleanup costs if it has sufficient involvement with a facility "that it could affect hazardous waste disposal decisions if it so chose." *U.S. v. Fleet Factors Corp.*, 901 F.2d 1550, at 1558 (11th Cir. 1990).

personally liable for the cleanup costs.[451] A trustee who does not have the power to control how waste is disposed should not incur personal liability.[452]

iii. Interests in Partnerships and Limited Liability Companies

a. General Partnerships. One hazard from owning a general partnership interest is that it could expose the community foundation's assets to the claims of creditors of the partnership. The risk of owning a general partnership interest depends on whether the owner, including a community foundation, is a full-fledged general partner or whether the owner is merely entitled to a share of the partnership's profits. It is not unusual for community foundations to enter into joint ventures, either philanthropic or for-profit, that could be treated as partnerships. If it joins such a venture as a general partner, a community foundation must be concerned about its legal exposure to claims by creditors of the partnership.[453]

By comparison, a community foundation has less likelihood of incurring such liabilities if it receives a general partnership interest as a gift.[454] Still, it might incur legal fees trying

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[451] *City of Phoenix v. Garbage Services Co.*, 827 F. Supp 600 (D. Ariz. 1993). See also Eugene Anderson and Henry Lower, "Trustee Liability Under CERCLA and Possible Insurance Solutions," *Trusts and Estates*, Aug. 1995, p. 46; Susan Campbell and Elizabeth Hook, "Trustee Liability Under Superfund," *New York Law Journal* March 30, 1993, p.1. See also *U.S. v. Northeastern Pharmaceutical and Chemical Co.*, 810 F. 2d 726 (8th Cir. 1986) where the president and vice-president of a corporation were held personally liable for environmental cleanup costs because of their ability to control how waste would be disposed.

[452] *City of Phoenix v. Garbage Services Co.*, 827 F. Supp 600, at 606 (D. Ariz. 1993). 42 (20) (A); In re *Bergsoe Metal Corp v. East Asiatic Co, Ltd*, 910 F. 2d 668 (9th Cir. 1990).

[453] The Uniform Partnership Act (UPA) is valid in all states except Georgia and Louisiana and governs the legal obligations of partners. It defines a partnership as "an association of two or more persons to carry on as co-owners of a business for profit." UPA Section 6. Thus, an enterprise that is not for profit (such as a cost-sharing cooperative or an association established for charitable or social objectives that a community foundation might be involved with) is technically not a general partnership.

Generally, partners are jointly and severally liable for the debts of the partnership and for torts committed by partners in the ordinary course of business. UPA Section 15. In a worst case scenario, this means that when a community foundation is a general partner of a partnership and another partner commits a ton, a creditor can seize the assets of the community foundation to satisfy the legal obligation.

[454] When a general partnership interest is assigned to someone (as, for example, a charitable contribution to a community foundation), the recipient generally does not have this exposure to liability. This is because the person is not a full-fledged partner until the existing partners agree to let him or her participate in management decisions. UPA Sections 6,7(l),18,27 and 28. An incoming partner will not be held personally liable for debts that existed before becoming a partner, but can be held liable for subsequent debts. UPA Section 17.

Sometimes this situation is referred to as a "sub-partnership." A "sub-partnership" consists of a group of owners of partnership interests who only receive profits but do not participate in management, they generally will not be liable to the partnership's creditors. Bromberg, Alan, *Crane & Bromberg on Partnership,* West Publishing Co. (1968), Section 28 (p.156-157). The owner of the partnership interest simply has the tight to receive the profits that the doctor would have received. UPA Section 27(1). The down side is that the owner has very few other rights; for example, there is no right to require the partnership to produce information or to even allow the owner to inspect the partnership books.

There are several risks which make the "sub-partner" classification much less desirable than that of a limited partner. First, the law concerning sub-partnerships is vague and old (most cases are from the 1800s; there are no statutes) whereas the laws concerning limited partnerships are better established. In to prove that it was not an active general partner. The safest course of action for a community foundation that wants to be a partner is to be a limited partner or a member of a limited liability company, described below.

b. Limited Partnerships and Limited Liability Companies. A community foundation that holds a limited partnership interest or an interest in a limited liability company (LLC) is usually not liable for the debts of the organization.[455] However, some limited partnerships and LLCs operate under agreements that contain provisions that can require the partners or members to contribute additional resources to the organization (a "capital call"). In addition, a limited partner of a limited partnership (but not an owner of an interest in an LLC) can be reclassified as a general partner if he or she takes part in the control of the business.[456] This rarely occurs. Instead, the more common problem with owning an interest in a partnership or an LLC is that it may cause a community foundation to be liable for the unrelated business income tax (UBIT), described below.

iv. Assets That Pose UBIT Problems

Certain assets can make a community foundation subject to the unrelated business income tax (UBIT). These assets include debt-financed assets, such as mortgaged real estate, and interests in general partnerships, limited partnerships, limited liability companies (LLCs) and limited liability partnerships (LLPs). If the UBIT applies, not only will a community foundation have to pay the tax, but it will incur additional administrative costs to establish more elaborate accounting systems and to prepare a separate tax return (Form 990-T "Exempt Organization Business Income Tax Return"). The laws governing the UBIT's application to these assets are analyzed in Section "B" below.

Unlike partnership interests, owning stock of a corporation will not normally subject a community foundation to the UBIT and will not normally expose it to liability for corporate debts. A possible exception applies if it owns a "controlled corporation" (at

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addition, there is the risk that a sub-partner community foundation might enter a grey area where it has not been formally accepted as a partner with management rights but it still has some involvement that could make it look like a full-fledged partner. If there are concerns about liability with a general partnership, the community foundation should clarify its role in writing in order to reduce the risk of a dispute.

[455] See Sections FIVE.A.4 and FIVE.B.3 below for additional information on partnerships and limited liability companies.

[456] A limited partnership has at least one general partner who conducts the partnership business and at least one limited partner who simply contributes money and shares in the profits. Like a partner of a general partnership, the general partner can be held fully liable for all of the partnership's debts. However, a limited partner will not be personally liable for any of the partnership's debts; a limited partner has limited liability. The price for getting this limited liability is that the limited partner must refrain from taking part in the control of the business. Such activity could cause the limited partner to be reclassified as a general partner. *Holzman v. De Escamilla*, 195 P. 2d 833 (1948).

The legal obligations of a limited partner are determined under state law. Most states have adopted either the Uniform Limited Partnership Act ("ULPA") or the Revised Uniform Limited Partnership ACE ("RULPA"). If there is a validly formed limited partnership with a properly filed Certificate of Limited Partnership, a limited partner who abstains from taking part in the control of the business will not be liable for partnership debts. ULPA Section 7 and RULPA Section 303. The result will be the same whether a community foundation obtains a limited partnership interest by purchase or gift.

least 80% of the stock of a for-profit or a tax-exempt corporation). Not only is the controlled corporation usually subject to the corporate income tax, but if the controlled corporation pays rent, interest, royalties or annuities (items that would normally be tax exempt) to the tax-exempt parent, then some or all of the payments could be taxable as unrelated business income.[457]

3. ASSUMPTION OF LIABILITIES AND CONTRACTS MAY BE A MATERIAL RESTRICTION

A donor might request the community foundation to assume mortgages, leases or contracts in connection with the contribution of property, or to refrain from selling the property. The assumption of such an obligation or restriction could be a "material restriction" that could make the fund (or at least that portion of the fund attributable to the property) a non-component fund. These restrictions, which are described in greater detail in Section THREE.C, include:

- Requiring the community foundation to retain the contributed property;
- Granting the donor a right of first refusal to purchase the contributed property;
- Assuming leases, contractual obligations, pledges or other liabilities of the donor; and
- Establishing irrevocable relationships for the maintenance or management of assets transferred to the community foundation.

C. Property That Can Trigger the Unrelated Business Income Tax

1. UBIT OVERVIEW: ITS PURPOSE; SITUATIONS WHEN IT OCCURS[458]

If the gross income from one or more unrelated trades or businesses exceeds $1,000 in any given year, then a community foundation must file Form 990-T, "Exempt Organization Business Income Tax Return" and pay any tax due. It must also make estimated tax payments if it expects its tax to be $500 or more.[459]

A preliminary comment is that paying unrelated business income tax is not necessarily bad. A community foundation will usually have some money left after paying the tax. Still, the payment of the tax and the added administrative complexities of preparing a separate tax return and allocating costs between UBIT activities and non-UBIT activities suggests that a community foundation should try to avoid incurring nominal amounts of

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[457] These rules are analyzed in-Section FIVE.B.5.
[458] A free publication from the IRS explains many of the detailed miles that apply to the UBIT: IRS Publication 598- "Tax on UBIT."
[459] It will be subject to an estimated tax penalty if insufficient payments are made through estimates. Generally, to avoid the penalty the amount of estimated tax payments must be 100% of the current tax year's liability.

unrelated business income if the costs exceed the benefits. If a community foundation is willing to incur the tax, it should reach an agreement with a donor that the UBIT and associated administrative costs will be assessed. directly against the fund or funds responsible for the tax. Furthermore, there should be adequate assurance that every affected fund will have adequate cash to pay the tax and associated costs, either from the investment income or from further contributions from the donor.

The most common situations when community foundations are likely to confront the UBIT is with acquisitions or contributions of rental property secured by a mortgage or interests in partnerships or limited liability companies. If the UBIT applies, the community foundation will have to file a separate tax return (Form 990-T) and may have to establish fairly extensive accounting systems to allocate its income and expenses between exempt and unrelated purposes.

a. Regularly Conducted Business Not Related to Exempt Purpose

The principal purpose of the UBIT is to put a tax-exempt organization on the same footing as a taxable organization when an activity is not directly related to its charitable function. The problem is one of unfair competition.[460] When a tax-exempt organization raises money by selling Christmas cards, it could have a competitive advantage over a for-profit corporation that sells the same cards but has to pay income taxes on its profits.[461]

Consequently, if there is a regularly conducted trade or business that is not substantially related to a charitable organization's exempt purpose, the income from the business is taxable at normal corporate or trust tax rates, depending on the legal form of the charitable organization.[462] There has been considerable hair-splitting as to what is "unrelated" and how expenses must be allocated between exempt activities and unrelated activities.[463] Probably the most common form of unrelated business income is advertising revenue from a tax-exempt organization's publications.[464] Gambling revenue

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[460] For the legislative history of the first UBIT legislation, see S. Rep. No. 2375, 81st Cong, 2d Sess, reprinted in 1950-2 CB 483, 504. See also McGovern, James J., "The Use of Taxable Subsidiary Corporations by Public Charities -A Tax Policy for 1988," *Tax Notes*, Vol. 38, No. 10, p.1125-1131 (Mar. 7, 1988) for an analysis of its evolution since then to the 1980s.

[461] The Tax Court held that a tax-exempt veterans organization's Christmas card program was a business, and its profits were subject to tax. *Veterans of Foreign Wars, Department of Michigan v. Commissioner*; 89 T.C. 7 (1987).

[462] Sections 511-513.

[463] The sale of milk and cream from an experimental dairy herd is an exempt way to dispose of surplus milk, but processing into ice cream and pastries is not. Treas. Reg. Section 1.513-1 (d) (4) (ii). The use of a theater in a museum for educational films is an exempt use, but after-hours use for ordinary entertainment is not. Treas. Reg. Section 1.513-1 (d) (4) (iii).

The IRS contends that a university's use of an auditorium for rock concerts triggers UBIT. Private Letter Ruling 9147008 and GCM 39863 (Nov. 26,1991). However, the IRS concludes that when volunteers sell clothing and merchandise at religious musical concerts there is no UBIT. Private Letter Ruling 9544029 (Aug. 5,1995).

[464] Treas. Reg. Section 1.512(a)-1(f), National Collegiate Athletic Association v. Commissioner, 92 T.C. 456 (1989). There was considerable controversy as to whether corporate sponsorships of college bowls games would be considered advertising or a charitable contribution and the IRS ultimately backed off.

(bingo, etc.) is also generally subject to UBIT.[465] A charity's sale of charitable gift annuities does not produce UBIT.[466] Although the Tax Court held that royalties from affinity credit cards are exempt royalty income rather than taxable income from a joint venture, the IRS has not given up on the issue.[467] Suffice it to say that there is a lot of gray area that can brighten an IRS auditor's day.

There are several IRS rulings that are of particular interest to community foundations. First, the IRS concluded that fees charged to administer advised funds will not generate UBIT.[468] Second, a community foundation can charge fees to private foundations for grant making services (e.g., reviewing grant requests and evaluating grant performance) without incurring UBIT.[469] Third, mergers of community foundations will not trigger UBIT.[470]

Wirtschafter, Nathan, "Fourth Quarter Choke: How the IRS Blew the Corporate Sponsorship Game," 10 *Exempt Org. Tax Rev.* 501 (Sept. 1994).

[465] Ann. 89-138, 1989-45 IRB 41.

[466] The ruling involved a college that was selling gift annuities as a way to help pay for college tuition. Private Letter Ruling 9527033 (July 7,1995).

[467] Although the IRS lost the affinity credit card case in *Sierra Club Inc. v. Commissioner*, 103 T.C. No. 17 (1994) (Affd 86 F.3d 1526 (9th Cir. 1996), it continues to argue that charities should be taxable on such revenue. See, for example, "Michigan Alumni Association Disputes UBTT Finding," 95 *Tax Notes Today* 68-9 (April 7, 1995).

[468] Private Letter Ruling 8936002 (May 24,1989). The ruling concerned an organization that was not a community foundation.

[469] In Private Letter Ruling 9347036 (Aug. 31, 1993), the IRS concluded that one community foundation had structured its operations in such a manner that the activity was "related," rather than unrelated, to its charitable purposes and the income was therefore not subject to UBIT. That community foundation amended its articles of incorporation to expressly state that one of its charitable purposes was to assist other charities by providing administrative services. It stated that such services "are of a kind and nature customarily provided by other community trusts and foundations." It then provided a variety of services at or below 90% of cost. The services focused on evaluating charitable grants; they did not include accounting or bookkeeping services that might have put the community foundation into competition with the private sector.

The IRS concluded that the grant making services accomplished charitable and educational purposes and also benefited the community. The specific services that the IRS approved were:

(i) coordination and response to all inquiries related to the particular organization's grant-making activities;

(ii) provision to potential applicant/donees of the particular organization's grant-making guidelines;

(iii) communication with potential applicant/donees regarding the status of applications and funding proposals;

(iv) conduct of site visits, interviews or other pre-grant inquiries necessary to obtain information to evaluate funding proposals;

(v) creation of proposal screening and evaluation processes considering the stated policies, purposes, and interests of the particular organization and relevant community needs;

(vi) presentation of grant making recommendations to the particular organization; (vii)assessment of grant impact,

(viii) other unique services that the community foundation could provide [this community foundation was the largest community foundation in the State].

One observation is that if the services are truly provided at 90% of cost, there would not be any UBIT even if the services were unrelated. The tax is only assessed upon a profit, not a loss. Still, the greatest significance of the ruling is its conclusion that the activity is related to the charitable purpose of a

b. Debt Financed Income

A second form of UBIT applies to "debt financed" income. Congress concluded in 1969 that tax-exempt organizations were able to use borrowed funds to acquire rental and other investment property at a competitive advantage over taxable organizations because a charity's investment income was normally tax free.[471] Thus, although charities generally do not pay tax on rental income, interest and dividends, these sources of income may be taxable under current law if they are attributable to "debt financed property" because of an underlying mortgage or debt.[472]

2. DEBT-FINANCED PROPERTY

Debt financed property is any property held to produce income if any "acquisition indebtedness" (debt the organization incurred to acquire or improve the property) is associated with the property.[473] For example, securities purchased on a margin account are "debt financed property.[474] The most common form of debt financed property is rental property that is subject to a mortgage.

An important exemption exists if the property is used for exempt purposes. For example, if a charitable organization which operates a thrift shop as part of its exempt purposes borrows money to purchase a building, 40% of which will be used for the thrift shop and 60% rented to miscellaneous tenants, then only 60% of the building will be subject to the debt financed property rules.[475] If 85% or more of the property is used for an exempt purpose, then none of the property will be treated as debt financed property.

Another important exception applies if the charitable organization received property by bequest or devise: any debt secured by a mortgage on that property at that time will not make the property debt financed property until 10 years after the time of receipt. If the encumbered property is received as a contribution from a living donor, it will not be debt financed property for 10 years following the time of receipt, but only if the donor held the property for more than five years and the mortgage was placed on the property more than five years before the date of the gift.[476] Neither of these exceptions apply if the charitable organization agrees to pay any part of the debt secured by the mortgage or if

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community foundation. This avoids the filing of a UBIT return and avoids frustrating arguments with the IRS over the allocation of costs between exempt and non-exempt activities.

[470] Private Letter Ruling 9203038 (Oct. 22, 1991). The IRS also concluded that a community foundation could sell real property (in particular, "Lease Fee Interests") without incurring the UBIT. Private Letter Ruling 9619068 (Feb. 12, 1996).

[471] Until the debt-financed UBIT legislation was enacted, this had occurred with some frequency with sale-leaseback transactions. S. Rep. 91-552, reprinted in 1969-3 CB 423, 464.

[472] Sections 512 (b) (4) and 514.

[473] Sections 514(b) (1) and 514(c) (1). However, retirement plans, educational organizations and Section 501 (c) (25) title-holding companies are permitted, under certain circumstances, to acquire and improve real property with indebtedness without triggering debt financed UBIT.

[474] *Elliot Knitwear Profit Sharing Plan v. Commissioner*, 614 F.2d 347 (3rd Cir. 1980).

[475] Treas. Reg. Section 1.514(c)-1 (a) (3).

[476] Section 514(c).

it pays for the donor's equity in the property.[477] Consequently, whether a gift of a building or land secured by a mortgage will constitute debt financed property depends on whether the community foundation agrees to assume the debt and when the donor placed the mortgage on the property.

A third exception that permits certain types of tax-exempt organizations to (the principally retirement plans and universities) acquire and improve real property was enacted into law in 1993. In general, acquisition indebtedness does not include debt incurred by a qualified organization in acquiring or improving any real property.

If none of the exceptions apply and a charity has debt financed income, it only has to pay tax on the portion of the income which is attributable to the debt.[478] For example, if an office building with a "tax basis[479] of $100,000 has an average mortgage balance for the year of $30,000 and produces gross rental income of $10,000, then only $3,000 will be considered unrelated debt financed income.[480] If the building is sold before the mortgage is paid off, a portion of the profit will be taxed as unrelated debt financed income.[481]

3. INTERESTS IN GENERAL PARTNERSHIPS, LIMITED PARTNERSHIPS, LIMITED LIABILITY PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

a. Overview

General partnerships, limited partnerships, limited liability partnerships and limited liability companies are generally treated for tax purposes as partnerships. If a community foundation owns an interest in one of these types of organizations, it will generally be subject to UBIT on its share of the profits. This is because it will be deemed to be indirectly engaged in an unrelated business. The tax will be imposed on the community foundation's share of the accounting income that is reported on Schedule K-1 of the partnership income tax return rather than on the amount of cash that the organization distributes to it.

b. Definitions

i. Partnerships

a. General Partnership. Section Six of The Uniform Partnership Act defines a partnership as an association of two or more persons who carry on a business for profit. Each partner is jointly and severally liable for all of the business' debts, including those

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[477] Section 514(c) (2) (B).
[478] Treas. Reg. Section 1.314 (a)-1.
[479] The tax basis is generally the cost of the building and its improvements, reduced by depreciation deductions. The tax regulations require the charity to compute the average tax basis for the year. Treas. Reg. Section 1.514(a)-1 (a) (2).
[480] Treas. Reg. Section 1.514(a)-1 (a) (1) (iv).
[481] Treas. Reg. Section 1.514(a)-1 (a) (1) (v).

caused by the negligence of fellow partners.[482] Many law firms are general partnerships.

b. Limited Partnership. A limited partnership has at least one general partner who conducts the partnership business and at least one limited partner who simply contributes money and shares in the profits. The general partner can be held fully liable for all of the partnership's debts. However, a limited partner will not be personally liable for any of the partnership's debts; a limited partner has limited liability. Examples of limited partnerships include real estate investments that were popular in the early 1980s. Very few limited partnerships are being formed today because the LLC is now viewed as a more attractive vehicle.

c. Limited Liability Partnership (LLP). The limited liability partnership (LLP) is a relatively new business form that is used principally by professionals such as attorneys and accountants. Some states have not yet passed legislation to recognize this new business form. It is different from a limited partnership despite its similar name. Generally, an LLP is the same as a general partnership except that a partner cannot be held personally liable for malpractice committed by some other partner. Many of the national CPA firms are structured as LLPs.

ii. Limited Liability Company (LLC)

The limited liability company (LLC) is also a relatively new business form that has been enacted into law in all 50 states within the past 10 years. It has the advantage of providing. its owners (who are called "members") with the same limited liability protection that corporations provide to their shareholders, yet it is treated for tax purposes as a partnership rather than a corporation. Although corporations are still the most common business form chosen by new businesses, LLCs are making strong inroads. Businesses of all types qualify as LLCs. Most tend to be small businesses and many are real estate operations.

c. Unrelated Business Income Tax

If a community foundation owns an interest in a partnership or an LLC that is engaged in a for-profit business, then the community foundation will be subject to the unrelated business income tax on its share of the organization's income even if it takes no active role in the businesses.[483] The reason is that the community foundation is indirectly

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[482] See supra n. 453 and the accompanying text for potential liabilities from being a general partner.

[483] The IRS successfully argued that a tax-exempt employee profit sharing plan had unrelated business income because it was a limited partner entitled to 90% of the profits of a limited partnership that distributed fasteners. *Sewire Boll & Nut Co. Profit Sharing Trust v. Commissione*r, 724 F.2d 519 (6th Cir. 1983). That court rejected the argument that the tax-exempt organization had to be actively engaged in the business; its passive, indirect ownership subjected it to the tax. The IRS has taken the position that the income from a general or limited partnership may result in unrelated business income; it did not specify any minimum percentage of ownership (nor does the statute or the regulations). Rev. Rul. 79-222,1979-2 C.B. 273, Section 512(c), Treas. Reg. Section 1.512(c)-1.

engaged in an unrelated trade or business. Furthermore, if the partnership or LLC has indebtedness, it may have unrelated debt financed income.

Larger, sophisticated tax-exempt charitable organizations have had considerable experience with partnerships, particularly with leases of depreciable buildings.[484] However, even smaller charitable organizations will be facing the issue. With the advent of limited partnership interests being traded on national stock exchanges (the most famous example being the Boston Celtics), a community foundation is more likely than ever to face inquiries about whether it will accept a limited partnership interest or an LLC interest as a contribution. A community foundation should establish a policy as to whether it will hold a partnership or LLC interest. If it will, there should be procedures to charge the taxes and expenses associated with that interest to specific philanthropic funds.

Whether every partnership or LLC interest will generate unrelated business income (UBI) is open to question. If the organization is formed for an exempt purpose (e.g., distributing food to the needy), there should be no UBI since the activity is directly related to the community foundation's function.[485] An investment partnership that holds only investments paying interest, dividend, rental and other passive income should not trigger UBIT, unless there is debt-financed income. At the other extreme is the partnership or LLC that operates a business with no relationship to a charitable function, in which case there is a good chance that the community foundation's proportionate share of income could be subject to UBIT even though it takes no active part in the business.

> The rules are contained in Section 512(c), which states in part:
>
> SPECIAL RULES APPLICABLE TO PARTNERSHIPS - If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall ... include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Although the statute does not directly address LLCs, the same rules will apply to LLCs that are treated for tax purposes as partnerships.[486]

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[484] For an analysis of the economics and laws concerning the establishment of partnerships and leasing arrangements see Chapter 42 "Tax-Exempt Organizations and Partnerships" (p. 829=843) and Chapter 43 "Tax-Exempt Entity Leasing Rules" (p. 844-854) of Hopkins, *The Law of Tax-Exempt Organizations* (John Wiley & Sons-5th Ed. 1987).

[485] See, for example, Private Letter Ruling 9105029 (Nov. 6, 1990) involving a hospital's participation in a partnership with a Subchapter S corporation to own and operate medical equipment.

[486] "Edited Transcript of the Sessions of the May 19, 1995 ABA EO Committee Meeting in Washington: Attachment C: Limited Liability Companies: Discussion for General Practitioners, Creditors and Non-tax Specialists," 12 *Exempt Org Tax Rev*. 77 (May 1995).

As an illustration, if a tax-exempt charitable organization is a partner in a partnership which operates a factory, it must include in its unrelated business taxable income its share of the gross income and deductions from the operation of the factory.[487]

However, the dividend and interest income of the partnership is usually not unrelated business income; only the profit from the business operation is. An exception (i.e., when a charity's share of a partnership's passive investment income could be subject to the UBIT) is if the partnership has debt financed income. Every partnership is supposed to provide its tax-exempt partners with the information necessary to determine the portion of the partnership's income that is UBI.[488]

The UBIT from a partnership or LLC interest can pose cash flow problems. The UBIT is assessed against the accounting income allocated to the partnership interest and not against the cash that is distributed to the partners. Consequently, if the taxable income reported by the partnership exceeds the partnership's cash distributions, there could be a cash shortage to pay the tax that will have to be satisfied with cash from other sources of the community foundation. Consequently, it might be advisable to obtain assurance from the donor that the fund will have sufficient cash to pay these taxes and costs.

d. Termination of Section 501 (c) (3) Status?

In a worst-case scenario, the IRS could attempt to revoke the tax-exempt status of a charitable organization that takes an active part in a business because its actions are not charitable. The controversy appears to be greatest when the activity involves the construction of housing. In 1993, the Tax Court concluded that a non-profit organization that acted as a general partner in a partnership to provide affordable housing to handicapped and low income individuals failed to qualify as a charity.[489] The IRS has raised the specter of revoking Section 501 (c) (3) status in other cases but it appears to be more willing to bend if the activities are connected with a clearly exempt purpose.[490]

4. SUBCHAPTER S CORPORATIONS

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[487] Treas. Reg. Section 1.512 (c)-1. See also the Senate Committee Report that stated that a partnership interest held by a charitable organization (whether a general partnership interest or a limited partnership interest) produced unrelated business income except to the extent that the income received by the partnership would have been exempt income to the charitable organization (e.g., dividends and interest). S. Rep. No. 1402, 85th Cong., 2d Sess. 2 (1958), reprinted at 1938-1 C.B. 636, 637.

[488] Section 6031(d), added by Section 5074 of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") Pub. L. 100-647. The partnership does not have to disclose the modifications contained in Sections 512 (b) (8)-(12).

[489] *Housing Pioneers, Inc. v. Commissioner*, T.C. Memo 1993-120. By comparison, in 1989 the IRS concluded in a technical advice memorandum that it would not revoke the tax-exempt status of a corporation that was a general partner of seven limited partnerships established to finance a housing project in a deteriorated urban area. The IRS also concluded that the income it received (developer and management fees) were not subject to the UBIT because they were directly connected with a charitable purpose. Private Letter Ruling 8938002 (May 31, 1989).

[490] Hopkins, "Tax Consequences of a Charity's Participation as a General Partner in a Limited Partnership Venture:. Commentary on the McGovern Analysis," 30 *Tax Notes* (No. 4) 361 (Jan. 27, 1986). See also Hopkins, *The Law of Tax Exempt Organizations* (John Wiley & Sons-5th Ed. 1987) at 832-843.

A Subchapter S corporation is treated for tax purposes in a manner similar to a partnership. - It rarely pays any income tax but, instead, the shareholders are liable for the income tax attributable to their share of the corporation's income each year.[491] A Subchapter S corporation is not subject to the general corporate income tax and its shareholders generally avoid paying any income tax on the dividends they receive from the corporation because they have already paid tax on their share of its accounting income. By comparison, most other corporations are subject to the corporate income tax and the shareholders are also liable for income tax on the dividends that they receive.[492] Many of the nation's smaller corporations have elected to be treated as Subchapter S corporations because of the favorable tax treatment.

Until 1988, a charity was prohibited from owning stock of a Subchapter S corporation. The stock of such a corporation could only be owned by shareholders who were human beings, estates of deceased shareholders, or specific types of trusts.[493] If a charity ever became a shareholder of a Subchapter S corporation, it was a disqualifying event that caused the corporation to lose its S corporation status on that day and converted it into a regular tax paying Subchapter C corporation.[494]

Beginning in 1998, a tax-exempt Section 501 (c) (3) charity, including a community foundation, can own stock of Subchapter S corporation. The down-side is that every penny of a . charity's share of a Subchapter S corporation's income will be treated as unrelated business income and will be subject to UBIT tax.[495] This includes the profit when the charity sells its Subchapter S stock.

5. 80% CONTROL OF A CORPORATION

An increasing number of tax-exempt organizations have established taxable subsidiaries, particularly in the health care industry.[496] Only a few community

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[491] Section 1366(a).
[492] Sections 11 and 301.
[493] Section 1361(b); Prop. Reg. Sec. 1.1361-1A.
[494] Section 1362. If a mistake is made and a charity becomes a shareholder, it may be possible to have the IRS forgive this disqualifying event as an "inadvertent termination." Section 1362(f). The charity would have to return the stock to the original shareholder and all of the corresponding adjustments to the corporation's income and records would have to be made.
[495] Section 1361 (c) (7) permits charities to be shareholders of Subchapter S corporations. Section 512(e) provides that all of the charity's share of the corporation's income will be subject to the UBIT. Section 512 (e) (1) (B) provides that the charity's gain from the sale of the stock will be subject to UBIT. The provisions were contained in Section 1316 of "The Small Business Job Protection Act of 1996," H.R 3448.

The tax is imposed on the charity's share of the Subchapter S Corporation's accounting income, rather than the amount of dividends that the charity receives. This could pose potential cash flow problems if the corporation has large amounts of income but distributes paltry dividends. In addition, a charity will have to pay tax even on the corporation's interest and dividend income.
[496] Between 1977 and 1986 the IRS issued 593 private letter rulings to tax-exempt organizations (435 of which were issued to health care organizations) concerning taxable subsidiaries, whereas only 8 similar rulings had been issued during the preceding 10 years. Part of the trend is attributable to the need to adapt to a changing economic environment. McGovern, James J., "The Use of Taxable Subsidiary Corporations By Public Charities -A Tax Policy for 1988," *Tax Notes*, Vol. 38, No. 10, p.1125-1131 (Mar.

foundations have established subsidiaries and they tend to be tax-exempt organizations that further the community foundation's charitable purposes. For example, a community foundation that covers a large geographic region or a community that crosses state lines might form a corporation to administer programs in a specific area. The corporation can hire its own staff and hold philanthropic funds. Most community foundations can classify their tax-exempt affiliates as component funds under the single-entity regulations and avoid separate tax returns.[497]

As a general rule, a for-profit subsidiary is not tax exempt merely because all of its profits will eventually be paid to a tax-exempt charitable organization.[498] Not only is the controlled for-profit corporation subject to the corporate income tax, but if it pays rent, interest, royalties or annuities (items that would normally be tax exempt) to the tax-exempt parent, then some or all of the payments could be taxable as UBIT (dividends, however, will not trigger the UBIT).[499] Congress' logic was that a taxable subsidiary, or a tax-exempt subsidiary subject to the UBIT, could take tax deductions for rent, interest, annuities and royalties paid (but not for dividends paid) and that a special provision was needed to subject the payments to the UBIT in order to close a loophole.

These rules only apply if a charity owns at least 80% of the stock of a for-profit or a tax-exempt corporation.[500] A blatant loophole to avoid the tax is to reduce its ownership to less than 80% and avoid these problems.[501] Another way is to have the charity's subsidiary have its own for-profit subsidiary (a second-tier subsidiary) make the payments to the charity; since payments come from an organization that is not owned directly by the charity, no tax is due.[502] Congress is aware of these transactions but has not done anything to correct it.[503]

Community foundations probably will not have to face this problem with most of the tax-exempt charitable corporations that they control. Under the single-entity regulations,

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7,1988); "IRS Official Addresses Popularity Of Taxable Subsidiaries," 95 Tax Notes Today 333 (Mar. 17, 1995). For an analysis of the economics and laws concerning the establishment of either a taxable or a tax-exempt subsidiary, see Chapter 40 "Combinations of Tax-Exempt Organizations" (p. 809-819) and Chapter 41 "Tax-Exempt Organizations and For-Profit Subsidiaries" (p. 820-828) of Hopkins*, The Law of Tax-Exempt Organizations*, (John Wiley & Sons - 5th Ed. 1987).

[497] Private Letter Ruling 8621112 (Feb. 28, 1986). See also the last sentence of Treas. Reg. Section 1.170A-9(e) (14) (i) which states that financial information of component funds are to be included on the community foundation's Form 990.

[498] Section 302.

[499] Section 512(b) (13).

[500] The test is whether the charitable organization controls at least 80% of the total combined voting power of all voting stock and at least 80% of the total number of shares of all other classes of stock. See, generally, IRS Publication 598 for a summary of the rules concerning the taxation of rents, interest, royalties and annuities paid by a taxable or tax-exempt "controlled corporation" to a tax-exempt parent.

[501] A hospital that owned 100% of a for-profit corporation transferred 21.67% of the stock to a related "supporting organization" for the sole purpose of reducing its ownership to 78.33%. The IRS approved the transaction and concluded that the interest payments that it received from the subsidiary would not be subject to UBIT. Private Letter Ruling 9324026 (Mar. 22, 1993).

[502] Private Letter Ruling 9338003; Tesdale, D. Benson, "Three Easy Ways To Avoid UBIT," 8 *Exempt Org. Tax Rev*. 937 (Nov. 1993).

[503] "IRS Official Addresses Popularity Of Taxable Subsidiaries," 95 *Tax Notes Today* 33-3 (Mar. 17,1995).

these corporations can often be treated as component funds.[504] Thus, they will not have to file a separate tax return but will be treated as part of the community foundation.[505] Another alternative is to have the separate charity classified as a supporting organization.[506]

[504] Treas. Reg. Section 1.170A-9 (e) G 1) (ii).
[505] Private Letter Ruling 8621112 (Feb. 28, 1986).
[506] See Chapter EIGHT for the laws governing supporting organizations.