THE UNRELATED BUSINESS INCOME TAX AND PAYMENTS FROM CONTROLLED ENTITIES

By Daniel Halperin

Daniel Halperin is the Stanley S. Surrey professor at Harvard Law School.

The unrelated business income tax now applies to deductible payments of interest, rent, or royalties received from controlled entities. The Tax Relief Act of 2005 (S. 2020), as just passed by the Senate, would modify that rule to tax only those amounts that exceed the sum that would be paid if the transaction were at arm’s length. Although that is meant to achieve consistency with third-party arrangements, it creates an advantage for the use of subsidiaries as opposed to direct ownership. Thus, Halperin says, fully consistent treatment of all alternatives is impossible. Moreover, he adds, the difficulty of enforcing an arm’s-length standard is obvious and unquestionably the IRS will not be fully able to preclude the exclusion of payments in excess of arm’s-length prices. Since it has not been shown that self-dealing between the parent and the subsidiary, as opposed to actually contracting with unrelated parties, is substantially more efficient, the report concludes that the proposed change would make the law considerably more complex and difficult to administer without any clear gain in efficiency.

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Introduction

Organizations “exempt” from tax under section 501(a) are nevertheless taxable on income from an unrelated business (hereafter UBIT). Although UBIT generally does not apply to dividends, interest, and other passive income, it does include certain passive income received from and deducted by a controlled subsidiary. The Tax Relief Act of 2005, as just passed by the Senate, would modify the definition of unrelated business income as it applies to payments from controlled entities to tax only those amounts that exceed the sum that would be paid if the transaction were at arm’s length. In 2003 both houses of Congress passed bills containing identical provisions, but that legislation was not enacted. I believe the recent Senate action is unwise.

Interestingly both supporters and opponents of this legislation argue that consistency with the treatment of similar situations supports their position. The purpose here is to resolve the conflict by considering both the theoretically correct solution and administrative feasibility. I conclude that fully consistent treatment of all alternatives is impossible and the proposed change would make the law considerably more complex and difficult to administer without any clear gain in efficiency. Therefore, the law should remain as is. At most the change should be limited to interest, and in lieu of an arm’s-length test, only interest that is no higher than the applicable federal rate should be tax-free to the exempt parent.

Initially, it is helpful to consider four possible means by which a tax-exempt entity may invest in an unrelated business. First, direct ownership using only its own funds. Second, direct ownership using, in part, borrowed funds. Third, transfer of the business to a subsidiary for

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1Section 511. Section references are to the Internal Revenue Code of 1986, as amended, except as otherwise noted.
2Section 512(b)(1), (2), (3), and (5).
3Section 512(b)(13).
4S. 2020, 109th Cong., section 306 (2005). As of this writing, the House companion bill, H.R. 4297, does not contain this provision.
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stock and cash, borrowed by the subsidiary. Fourth, transfer to a subsidiary in return for stock and debt issued by the subsidiary.

Case I: The exempt organization invests $1 million in an unrelated business, which produces an annual profit of $150,000. That amount is taxable as unrelated business income.

Case II: The EO similarly invests $1 million in an unrelated business but borrows $400,000 at 10 percent interest and invests only $600,000 of its own money. The interest deduction ($40,000) reduces taxable income to $110,000. The EO may lend the $400,000 it did not invest in the business to unrelated parties without incurring tax liability on the interest earned. If ownership of real estate or intangibles used in the business increases net taxable income, the EO may further reduce its taxable income by renting real estate used in the business rather than purchasing it or by licensing rather than acquiring intangible property used in the business.

Case III: The EO transfers the business it acquired for $1 million to a wholly owned taxable subsidiary for $400,000 cash and $600,000 of stock. The subsidiary borrows the $400,000 from an unrelated party at 10 percent interest. The subsidiary earns $150,000 and has taxable income of $110,000, after deducting $40,000 of interest. The parent may lend the $400,000 in cash received from the subsidiary to unrelated parties without incurring tax liability on the interest earned. (The subsidiary may further reduce its taxable income by renting the real estate used in the business rather than purchasing it as part of the acquisition of the business or, similarly, licensing rather than acquiring intangible property used in the business. The parent could sell the real estate or intangible property to unrelated parties and use the cash for unrelated investments, which would not produce income subject to UBIT.)

Case IV: The EO transfers the business it acquired for $1 million to a wholly owned taxable subsidiary in return for debt of $400,000 (paying interest at 10 percent) and $600,000 in stock. The subsidiary has taxable income of $110,000 ($150,000 less $40,000 of interest paid to the parent). (The subsidiary may further reduce its taxable income by renting the real estate used in the business from the parent rather than purchasing it as part of the acquisition of the business or, similarly, licensing rather than acquiring intangible property used in the business.)

The question is whether the parent should be taxable on the $40,000 of interest received from the subsidiary. If yes, total taxable income is $150,000 (subsidiary $110,000 and parent $40,000) as in Case I. If not, taxable income is only $110,000 as in Cases II and III. Similar questions arise if the subsidiary pays rent or royalties to the parent.

The Case for Section 512(b)(13)

UBIT was expanded in 1969 to include certain passive income received from a controlled subsidiary. Addi-


7Taxpayer Relief Act of 1997, P.L. 105-34, section 1041, 111 Stat. 788, 938-39. Until that time, because attribution rules did not apply, this section could be easily avoided by the use of a second-tier subsidiary to own the business. Control also required 80 percent ownership. Now, because more than 50 percent ownership is deemed to be control and attribution applies, the provision has much more force. See H.R. Rep. No.105-148 at 491 (1997), reprinted in 1997-4 C.B. 319, 813; S. Rep. No. 150-33 at 168 (1997), reprinted in 1997-4 C.B. 1067, 1248.

8Section 512(b)(13).


7In the absence of section 512(b)(13), an exempt corporation operating an unrelated business could reduce taxable income by transferring the business to a newly created controlled taxable subsidiary, as in Case IV. The EO would retain ownership of real estate or intangibles that could be rented or licensed to the subsidiary. In addition, on the transfer, the parent would receive a significant amount of debt in addition to stock. Because the subsidiary could deduct interest, rent, and royalties, its taxable income could be significantly less than the business income of $150,000 previously earned by the parent. However, because of the passive income exception, the exempt parent would not be taxable on the payment from the subsidiary.

By including passive income received from a controlled subsidiary “to the extent such payment reduces the net unrelated income of the controlled entity,” section 512(b)(13) achieves parity between direct operation of a business by a EO (Case I) and the transfer of the business to the subsidiary (Case IV). Because the interest and other payments deductible by the subsidiary would be taxable to the parent, the entire $150,000 of earnings from the business would be taxable to either the parent or the subsidiary, as would be true if the business were entirely owned by the parent.

Arguments by Proponents of Amendment

Now that section 512(b)(13) has teeth, for the past several years Congress has been considering legislation that would limit taxable payments from controlled entities to the amount that would exceed the sum that would be paid in an arm’s-length transaction between unrelated parties. Proponents of that legislation assert that the diminution of taxable income, which would be achieved by the transfer to the subsidiary, is appropriate. They have compared the result with Case III, in which, rather than issuing debt to the parent, the subsidiary pays cash by borrowing the $400,000 from an unrelated party. In that case, the subsidiary would have taxable income of $110,000 after deducting $40,000 of interest (assuming a 10 percent rate). The parent may lend the $400,000 in cash received from the subsidiary to unrelated parties without incurring tax liability on the interest earned.
In short, if the exempt parent and the taxable subsidiary each transacted with unrelated parties, interest, as well as rents and royalties, received by the parent would be excluded from tax. At the same time, the subsidiary could deduct interest, rent, and royalties paid to unrelated parties. It is asserted that there is no reason to collect any more tax when the parent and the subsidiary deal with each other at arm’s length. Hence interest, rent, or royalties paid by the subsidiary to the parent should be tax-free as long as the amounts do not exceed the sum payable in an arm’s-length transaction.12

In support of that claim, it is suggested that the 1997 committee reports are clear that section 512(b)(13) was “enacted to prevent subsidiaries of tax-exempt organizations from reducing their otherwise taxable income by borrowing, leasing, or licensing assets from a tax-exempt parent organization at inflated levels.”13 (Emphasis added.) The Blue Book, explaining the Tax Reform Act of 1969, implies a similar rationale.14

To buttress their argument, critics of section 512(b)(13) also assert that it is more efficient in certain circumstances to self-finance or to own the real estate used in the business, rather than borrow or lease from outsiders.15 It is suggested that current law leads to a restructuring of financial arrangements (departing from contractual arrangements with subsidiaries), which often does not make business sense.

A Reply to the Proponents of Change

Opponents note that fully consistent results in all circumstances would not be achieved under the pending legislation.16 Under the legislation, a business operated directly by an EO (Case I) would pay higher taxes than would be due if the business is transferred to a subsidiary that made deductible payments that were not taxable to the parent (Case IV). In fact, in 1997 the JCT set forth an additional explanation for section 512(b)(13) that suggests that concern.17 It stated that even if payments satisfied an arm’s-length standard, the section is intended to prevent a tax-exempt parent from obtaining a tax-free return on capital invested in the subsidiary. Of course, a tax-free return on debt, rent, or intangible property owned by an EO would not be abnormal. Therefore, for the statement to make sense, the JCT must be alluding to the fact that the parent would be getting a tax-free return on assets used in the subsidiary’s business that it could not achieve if the parent operated the business directly.

If the legislation is enacted, symmetry could be achieved between direct and subsidiary ownership only by imputing a deduction for “interest,” “rent,” or “royalties” in the case of a directly owned business. I explore here whether an analysis of the purpose of UBIT would suggest that it would be logical to determine taxable income by measuring what a business would earn if its debt were maximized or at least averaged, it rented real property instead of owning, and, perhaps, licensed all intangibles. My analysis suggests that this argument is defensible. Nevertheless, I support current law because it is simpler to administer and it sensibly encourages EOs to diversify. In short, the difficulty of enforcing an arm’s-length standard is obvious and the task should not be undertaken unless it can be shown that self-dealing between the parent and the subsidiary, as opposed to actually contracting with unrelated parties, is substantially more efficient. That case has not been made.

The Purpose of UBIT

Supporters of UBIT refer to fairness to competitors, potential revenue loss, and efficiency in both business operation and investment choice by EOs. For example, when UBIT was first enacted in 1950, the committee reports18 referred to the potential unfair competitive advantage for exempts, which would have pretax profits available for expansion. Moreover, because they neither had to pay taxes nor provide a return on equity capital, exempt organizations were said to be able to cut prices, thereby driving out competitors.

Many have suggested that the concern for unfair competition is misplaced. In an efficient capital market, access to capital by avoiding tax should not provide EOs with an unfair advantage. For-profit companies pay tax but have the offsetting and larger advantage of access to equity markets. Moreover, an EO has no reason to charge below-market prices.19 Because, assuming a competitive market, all investments must have an equal expected return, adjusted for risk, an EO that cut prices would earn a subnormal return, presumably less than it would earn, as adjusted for risk, from passive investing. It would seem unlikely that an EO could often hope that a “temporary” price cut would permanently eliminate competitors so that in the future they could achieve extraordinary returns by raising prices above normal.20 To some that means that UBIT has no justification.

However, some observers have noted that this analysis fails to take into account the effect of the corporate tax. Prof. Hansmann has suggested that UBIT is needed to impose a tax on profits from direct ownership of a business to replicate the corporate tax that burdens the

11 Because, with limited exceptions, rents on personal property are taxable even if received from unrelated parties, we are concerned mostly with rents on real property. Section 512(b)(3)(A)(ii), (B)(i).


14 See Gutman, supra note 10, at 49.

15 Schler, supra note 9.


EO’s share of corporate income. Otherwise, in the absence of UBIT, EOs would have an incentive to avoid the corporate tax by selling their portfolio holdings and directly acquiring one or more businesses now owned by publicly traded corporations. Because that behavior would have implications for revenue collection, equity, and efficiency, the role of UBIT is to prevent it from occurring.

To explain, because of the existence of the double tax on corporate profits, it is sometimes assumed that, to prevent the double tax from leading to an inadequate return, public corporations must earn a higher pretax rate of return than the return on other investments. Therefore, the corporate base is assumed to shrink until the reduced supply of goods enables corporations to increase prices and profits so, after the corporate tax, the expected return is equivalent to the pretax return from other investments. For example, if the normal rate of return were 10 percent and the corporate tax took one-third of the profits, a corporate business could be expected to earn 15 percent.

An organization that had the ability to compete for assets normally owned by publicly traded corporations, but could avoid the corporate tax, might have an opportunity to make an extraordinary return. Therefore, in the absence of UBIT, it could make sense for EOs, with a large accumulation of capital or ability to borrow significant sums, to directly acquire a business now operated in corporate form. Those acquisitions could be facilitated by the fact that exempts might be willing to pay a higher price than that offered by other buyers. That may be so because the elimination of the corporate tax could provide an above-normal return even if the higher price reduced the before-tax return below that earned by the seller. Previous holders of the stock of the acquired company would replace nonprofit entities as shareholders of the remaining corporations or hold other investments, such as loans to nonprofits that borrowed money for the purpose of acquiring a business.

Because the EO would be acquiring a taxable business previously conducted in the corporate sector, elimination of the corporate tax would result in a loss of revenue. UBIT, by replicating the corporate tax, deters that activity. Thus, if UBIT applied to the directly owned business, it would reduce the return (on an efficiently operated business) from 15 percent to 10 percent and there would be no reason to prefer direct ownership to a portfolio of investments.

Also, in the absence of UBIT, the potential higher return from directly investing in one or a few businesses could inefficiently entice an EO to put all its eggs into a few baskets, buying a business even if it could not operate it efficiently. As long as it could earn more than 10 percent, it would earn more than it could on other investments. For similar reasons, it might have an incentive to cut prices.

Moreover, an EO may be willing to enter into a business in which for-profits are just making 15 percent, even though the result of additional entrants would be to drive profits below the level necessary to provide a fair rate of return on investment for for-profit companies. Thus, in addition to the potential harm to the EO from an undiversified portfolio, there is both potential unfair competition and harm to society because a nonprofit, rather than the most efficient operator, is running the business. Again UBIT, by replicating the corporate tax, could deter the inefficient investment choices that would otherwise be made by exempt organizations. Thus, EOs have an incentive to engage in a related business when UBIT would not apply.

In short, concerns as to equity or fairness to potential competitors, revenue, and efficiency may all be implicated in the incentive EOs would have in the absence of UBIT to liquidate equity holdings in the market and....

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22To achieve this result, the nonprofit, which purchased stock, would have to liquidate the corporation. Under current law, that liquidation would trigger a tax to the extent that the value of the corporate assets exceeds their basis. Section 337(b)(2). That would correspond to the tax paid by the seller if the nonprofit bought assets.
24Because of the increased supply of capital outside the corporate sector, the rate of return on these investments declines so the burden of the corporate tax is shared by all investors.
25Some observers reject the idea that corporations earn such excess returns. Under the “new view,” it is believed that, because the source of the marginal investment by corporations is retained earnings or debt, rather than new equity, the marginal return on corporate investment need not be extraordinary. Under that view, however, to reflect the extra corporate tax, existing stock would sell at a discount from the fair market value of the assets. Corporate assets would sell at a discount as well. Again, that may offer an organization that can avoid the corporate tax an opportunity to make an extraordinary return by buying stock or assets worth full value to it, at a discount.
26Individuals can avoid the corporate tax by using nontraded limited liability companies, taxed as partnerships, or subchapter S corporations. Thus, they would have an incentive to operate their own business rather than invest in a diversified portfolio of stocks. Although individuals generally might not have access to enough capital to do that efficiently, small businesses may count on the extra tax burden imposed on large competitors to offset their cost advantage.
directly acquire a business now operated by publicly traded corporations. Thus, UBIT sensibly deter attempts by EOs to avoid the corporate tax that applies to their share of corporate income when they hold traded securities.

**Application to Controlled Subsidiaries**

If the goal of UBIT were merely to replace the corporate tax, it would follow that it need not apply to income not ordinarily earned by a corporation. The scope of the exemption for passive investments could depend on this factor. UBIT was not applied to dividends, interest, and other passive income on the stated grounds that the risk of competition was not as great and, as the normal form of investment, it was presumably intended to be nontaxable. The absence of a need to protect the corporate tax base may be a more convincing rationale.

That explanation for UBIT also lends support to limiting taxation of interest (and other deductible amounts) paid by a controlled business to the parent to amounts that exceed the sum that would be paid in an arm’s-length transaction. That approach could be said to limit UBIT to the portion of profits that represents the usual return to stockholder equity, that is, the portion that would need to earn an above-market return to compensate for the double tax.

To explain, because corporations can avoid the double tax to the extent they are debt financed, it seems logical that even if there were an extraordinary return on corporate investment, it would be limited to the portion normally financed by equity. Thus, assume a $1 million investment but only $600,000 of shareholder equity, because debt financing normally represents 40 percent of capital. Even if equity earned a 15 percent return, the expected return need be only $130,000, not $150,000. If the corporation borrowed $400,000 at 10 percent, $40,000 would be paid in interest, leaving a $90,000 profit, 15 percent of $600,000 of shareholder equity. After the corporate tax, there would be $60,000 left, a 10 percent return for shareholders who supplied $600,000.

If that is true, an EO that did not borrow and invested $1 million in the business would earn $130,000 or a 13 percent return. If UBIT were applicable to the entire income, it would reduce the 13 percent return to 8.66 percent (or $86,667), a subnormal return. To avoid that result, previously the EO could transfer the business to a controlled entity in return for stock and $400,000 of debt. After the interest payment ($40,000), the subsidiary would retain $90,000, on which tax of $30,000 would be due. The total return for the parent and subsidiary would be $100,000 and both the parent and the subsidiary would earn 10 percent.

The argument that UBIT is designed to replace the corporate tax on the “normal” return to equity could provide theoretical justification for imputing interest and rent deductions and perhaps royalties when the EO directly operates the business. That would achieve consistency in all cases. However, it seems clear that this approach would be viewed as administratively difficult. How would we identify the “usual” level of borrowing or determine the appropriate rate? If that were the case, why should it be any less problematic to determine arm’s-length prices or the “normal” level of debt when the parties split the business between the parent and the subsidiary and purport to make what would be claimed to be arm’s-length payments? That concern suggests that the law should remain as is.

However, as noted above, current law deters an EO from dealing with a controlled entity or conversely favors it dealing with third parties. By dealing with outsiders, an EO could avoid tax on interest, rent, and royalties that would be taxable if received from a controlled entity. That distinguishes the EO from a taxable corporation that is taxable in either case. It is asserted that this preference for dealing with outsiders could be inefficient. If that is so, it leads to the question of whether the purported advantage of facilitating relationships between the exempt parent and a subsidiary could justify undertaking the difficult task of measuring arm’s-length prices.

**Efficiency of Dealing With Subsidiaries**

Critics of section 512(b)(13) claim that it is more efficient in some circumstances to self-finance (or at least own the real estate used in the business), rather than borrow (or lease from outsiders). Therefore, it is suggested that current law, by favoring a switch from contractual arrangements with subsidiaries to contractual arrangements with third parties, causes a restructuring of financial arrangements in ways that would not make business sense.

However, unless there is some sort of market imperfection, if the loan were truly at arm’s length, the subsidiary could borrow from an unrelated party on the same terms. There would be no reason to borrow from the parent. The parent may be willing to make a loan at below-market rates, but in those circumstances it is more difficult to claim that the parent is not still directly engaged in the business. Similarly, if the EO is unwilling or unable to license an intangible to a third party, perhaps because it will reduce the overall profit from the activity, it signals that the exempt wants to remain actively engaged as opposed to being a passive licensor. The

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33Hansmann, “UBIT,” supra note 21, at 626. If that were the theory, perhaps it would not make sense to tax rentals when they are based on the income of the lessee as the code now does. Section 512(b)(3)(B)(ii).


35See Gutman, supra note 10, at 49.
greater likelihood that the parent will remain involved in the business, as opposed to an arm’s-length relationship, weakens the claim that taxation of income from subsidiaries would be identical to taxation of income received from outsiders.

Moreover, if taxes were reduced by dealing with third parties, the nonprofit would be encouraged to diversify its investments, which, as discussed above, could be viewed as a goal of UBIT. That suggests that a strong case cannot be made for adopting an arm’s-length standard, even if it involves only a relatively minimal administrative burden.

**Difficulty of Arm’s-Length Standard**

Supporters of amending section 512(b)(13), however, suggest that the burden of enforcing an arm’s-length standard is not that significant. They note that the IRS has a great deal of experience determining fair market prices for other purposes, most importantly transfer pricing under section 482. In the case of EOs, the imposition of so-called intermediate sanctions requires the IRS to determine whether transactions between nonprofits and related parties reflect market prices. It is further suggested that the issues involved under section 512(b)(13) are not those that cause most of the controversy under section 482. To quote one letter to the Treasury:

Fair market interest rates can be readily determined through the use of applicable federal rates, and real estate rentals are in most cases readily determined through market comparables. While the determination of a fair market price for the use of intangible property can be more complex, the section 482 regulations provide relatively clear guidance for developing reasonable transaction prices.

I believe that this statement substantially underplays the difficulty of enforcing an arm’s-length standard. It is true that the code often requires that interest be charged at the so-called applicable federal rate (AFR), which is the rate paid by the United States on loans of similar duration. Those rates now apply to situations in which the use of below-market interest rates would be abusive. Because the federal rate would almost certainly be below the market for individuals, the very enactment of that generous approach demonstrates the difficulty of determining the true market interest rate in particular cases.

In the case of interest paid by the subsidiary to the EO, the potential abuse is the use of above-market rates. Thus, use of the federal rate to set a maximum rate, if satisfactory to the parties, would be both administrable and protective of abuse. However, the parties could justifiably claim that the market interest rate, which the subsidiary would have to pay, would be higher than the applicable federal rate. The regulations under section 482, which in fact allow a safe harbor of 130 percent of the federal rate, reflects that concern. That rate could be too high and is, in any event, only a safe harbor. In my view, a rule allowing a parent to receive arm’s-length interest tax-free would be administrable only if the AFR is the maximum rate allowed.

Moreover, even if the rules for determining an arm’s-length price for the licensing of intangibles could be said to “provide relatively clear guidance,” they are no doubt lengthy and complex, offering a choice of three detailed approaches plus additional unspecified methods. That led to complex, fact-laden litigation in a number of instances and presumably many more detailed administrative proceedings. The potential difficulty of determining market rents is illustrated by section 119(d)(2), which allows the parties to use 5 percent of the appraised value of the property in specified circumstances.

The fact remains that the determination of fair market rents and royalties is a heavily fact-laden process that requires time and resources. Unquestionably, the IRS will not be able, in all cases, to preclude the exclusion of payments in excess of arm’s-length prices. Further, when one is transacting with a related party, it is certainly easier to disguise payments for services or other business activities that would be taxable to the parent as, perhaps, royalties.

Thus, it seems impossible to ignore the difficulty of enforcing an arm’s-length standard. Since the goal should be, whenever possible, to reduce the burden on the IRS, the fact that the IRS has to deal with similar issues in other circumstances does not, in itself, justify imposing an additional burden. We should require a showing of very strong reasons why it is important to facilitate self-dealing and to encourage the transfer of an unrelated business operated by an exempt parent to a subsidiary. In my view, that case has not been made.

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36Section 4958.


38Section 1274(d). See sections 467(e)(4) (using 110 percent of the AFR), 483(b), 1274(b)(2), and 7872(e)(1). See also Treas. reg. section 1.1275-4(b)(4)(ii)(B) (in certain circumstances requiring the use of the applicable federal rate in the “absence of clear and convincing evidence” to the contrary).


40In some section 482 cases, courts and the IRS have used the 130 percent safe harbor rate as the presumptive arm’s-length rate. See, e.g., Cordes v. Comm’r, 83 T.C. (CH) 1673, Doc 2002-12455, 2002 TNT 100-14 (2002). While I believe that rate may be too high, it shows the administrative appeal of using a fixed rate, rather than determining a rate case-by-case.

41Treas. reg. section 1.482-4 (setting forth alternatives for determining arm’s-length prices in the case of transfers of intangible property).


43Because the tax result is unchanged from direct operation, section 512(b)(13) does not prevent a nonprofit from operating through a subsidiary if that makes sense for other reasons. It is asserted that if what is claimed to be a related business grows too much in size, the exemption for the organization may be in jeopardy. Some believe that transferring the business to a subsidiary reduces this risk but also increases the possibility that the IRS will succeed in a claim that the business is unrelated and therefore taxable under UBIT. If interest, rent, and royalties

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Conclusion

I agree that the strongest argument for UBIT is the need to replicate the corporate tax to eliminate the incentive for EOs to liquidate market investments in favor of directly operating a business. That direct ownership raises concerns as to equity or fairness to potential competitors, revenue, and efficiency, in both business operations and investment choice by exempts. Given that rationale, it could be argued that allowing an imputed deduction for a reasonable allowance for interest, rent, and possibly royalties would more accurately measure the income that should be subject to UBIT. Nevertheless, payable to the parent were deductible, the burden of UBIT is mitigated making the subsidiary option more appealing than it is under current law. Fair enough — but I fail to see the tax policy concern that suggests that this “dilemma” must be eliminated.

such a rule, which would raise serious administrative difficulties, would be unlikely to receive serious consideration and it is not obvious that those difficulties are significantly mitigated when a subsidiary purports to formally pay reasonable interest, rent, and royalties to a parent.

Moreover, the argument that section 512(b)(13) interferes with efficient business practices is not overwhelming. If the transaction is truly arm’s length, there is no need to self-finance (or otherwise engage in self-dealing). Also, it is wise to encourage diversity as current law does by providing a preference for outside financing of a business acquisition or operation. For those reasons, I stand by the conclusion that a change in the law is unwarranted. In any event, if the law is to change it should affect interest payments only, and only if interest does not exceed the applicable federal rate. But even that approach does not eliminate the risk that the level of debt could be excessive.