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A Letter to Representative Wilbur D. Mills, Chairman, House Ways and Means Committee regarding H.R. 12663, a Bill to Impose a Tax on Unrelated Debt-Financed Income of Tax-Exempt Organizations'

American Institute of Certified Public Accountants. Committee on Federal Taxation

TAX COMMITTEE COMMENTS AND RECOMMENDATIONS

A Letter to Representative Wilbur D. Mills, Chairman, House Ways and Means Committee regarding H.R. 12663, a Bill to Impose a Tax on Unrelated Debt-Financed Income of Tax-Exempt Organizations

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February 19, 1968

The Honorable Wilbur D. Mills
Chairman, House Ways and Means
Committee
1134 Longworth House Office Bldg.
Washington, D. C.

Dear Mr. Mills:

On August 28, 1967 you introduced H.R. 12663, a bill to impose a tax on unrelated debt-financed income of tax-exempt organizations.

The Institute's committee on federal taxation has studied H.R. 12663 and submits for your Committee's consideration our comments and recommendations on the bill.

This proposed legislation goes significantly beyond what is necessary to deal with a Clay B. Brown-type transaction. It embraces the entirely new concept that virtually any type of income derived by an exempt organization from the use of borrowed funds shall be taxed differently than the same or similar income derived from the use of corpus. We urge that the scope of the bill be limited to the avowed purpose of extending the unrelated business taxable income concept to income arising from Clay B. Brown-type transactions.

We further recommend the following specific revisions to H.R. 12663:

1. Proposed Code Sections 514(b), 514(d)(1), and 514(e) - The proposed rules may subject an exempt organization to a tax liability under circumstances where no tax avoidance or genuine "debt-financed" acquisition is involved, and where we are sure no tax was intended to apply. Assume that an individual owns stock (or land, or any other property) with a basis of $3,000, subject to a

loan (less than 5 years old) of $3,000, with a current value of $10,000. He makes a charitable contribution of the property, subject to the loan. The recipient charity puts the property up for sale promptly. In due course it is sold, the loan paid, and the remaining proceeds (the charitable contribution received) applied to charitable purposes. There will be a basis of $3,000 and an acquisition indebtedness of $3,000. The percentage described in Section 514(b) will be 100 percent. The gain of $7,000 ($10,000 proceeds less $3,000 basis) will therefore be fully taxable--surely an unintended result. The same result might even follow in the frequently arising situation where a charitable donor sells property to a charity at a bargain price. The purchase price itself, if it remains unpaid for only a few days, could be "acquisition indebtedness." To prevent this result, it should be provided that property acquired by gift or bargain purchase shall not be treated as "debt-financed property" if the exempt organization, within a short time after acquisition, takes bona fide steps to dispose thereof and does in fact dispose of it within a time which is reasonable taking into account the nature of the property.

2. Proposed Code Section 514(e)(7) - In computing the percentage of any gain or loss to be taken into account upon a sale or other disposition of debt-financed property, the term "average acquisition indebtedness" should be defined in a manner parallel to that in which it is defined for other purposes, i.e., the average amount of the acquisition indebtedness during the 12-month period ending with the date of the sale or other disposition. It appears inequitable to use the highest amount of acquisition indebtedness during the 12-month period.

3. Proposed Code Section 514(d)(2) - The requirement that the tax be paid currently subject to later refund if the conditions of proposed Section 514(d)(2)(B) are met, may harm some exempt organizations. For example, a university may be struggling under the financial burden of relocating its campus, or may be establishing another campus, and cannot meet the neighborhood test. It does actually satisfy the use condition within ten years. If the university must pay tax on income earned from the property, it may be seriously handicapped if it depends upon the earnings to help finance the project. The later refund does not make the university whole, because it may have needed the money earlier. It is therefore suggested that,

where the circumstances contemplated by Subparagraphs (B) and (D) arise, provision be made for disclosure requirements, for holding the statute of limitations open, and for payment of the tax if the conditions are ultimately not met. Interest at the rate of 6 percent would, of course, be payable.

4. Proposed Code Section 514(d)(2)(D) - If this section is not revised in accordance with the immediately preceding recommendation, the rate of interest on any overpayment should be the regular rate of 6 percent. There is no reason for the lower rate of 4 percent.

5. The reference in Section 4 of the bill on page 18, line 10, should be to "Section 514(d)", not to "Section 514(c)."

6. Proposed Code Section 514(e)(6) - This subsection provides that "acquisition indebtedness" does not include an obligation insured by the Federal Housing Administration under Section 221(d)(3) or 231 of Title II of the National Housing Act, nor a loan made by the Housing and Home Finance Agency. While this relief may be commendable from a social point of view, it raises the question why other perhaps equally worthy loans are not granted equal relief, such as loans made for the purpose of constructing nursing homes which are insured under another section (Section 232) of Title II of the National Housing Act. Furthermore, it might be asked why any relief should be given at all if the true purpose of the bill appears to be to prevent the acquisition of income-producing assets by exempt organizations through the use of borrowed funds.

7. Proposed Code Section 514(b) - It appears grossly inequitable to deny to an exempt organization the benefits of Section 334(b)(2) and to deprive it of the tax benefit of costs which it has actually incurred in acquiring the property.

8. Proposed Code Section 514(c)(3) - The specific deduction of $1,000 should be increased. This would eliminate unrelated debt-financed income of many smaller organizations with transactions dissimilar to that in the Clay B. Brown case. It might also reduce the administrative burdens of such organizations and of the Internal Revenue Service.

We would be pleased to provide any amplification of these remarks which you deem necessary.

Very truly yours,

Donald T Burns

Donald T. Burns, General Chairman
Committee on Federal Taxation

DTB:cm

cc: Other Members of the
House Ways and Means
Committee