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Joseph C. Mandarino
King & Spalding

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Recent Changes to the Internal Revenue Code May Require Tax-Exempt Hospitals to Restructure Ownership of Certain Activities

*Joseph C. Mandarino**

INTRODUCTION

In 1997, Congress amended the Internal Revenue Code to close a loophole that had allowed tax-exempt organizations to operate for-profit businesses on a tax-free basis. Many hospitals are tax-exempt entities and own or operate such for-profit businesses. Accordingly, this change in the law may force such hospitals to restructure the ownership or operation of such businesses. Part I of this Article describes the law as it existed prior to the amendment and some common transactional structures that were implemented to take advantage of the loophole. Part II discusses the new law, the tax consequences it will have on arrangements structured under prior law, and several issues that are unresolved by the new law. Part III concludes by offering suggestions that may be implemented to avoid application of Internal Revenue Code section 512 (b) (13).

I. LEGAL BACKGROUND

A. *Taxation of Commercial Business Activities of Tax-Exempt Organizations*

Organizations can qualify for tax-exempt status under the Internal Revenue Code¹ based on the nature of their activities.² For example, a not-for-profit hospital can obtain tax-exempt sta-

* Mr. Mandarino is an attorney with King & Spalding in Atlanta, where he practices exclusively in the area of federal income taxation, with an emphasis on structuring transactions to minimize or defer taxation. Mr. Mandarino received his Juris Doctor *cum laude* from Loyola University School of Law, where he served as Managing Editor of the Loyola Law Review. He received his LL.M. in taxation from New York University School of Law. He is a member of the Georgia, District of Columbia, and Louisiana Bars.

1. Hereinafter, all references to the "Code" and all section references are to the Internal Revenue Code of 1986, as amended (26 U.S.C. §§ 1-9833).

2. See, e.g., I.R.C. §§ 115, 401, 501 (West Supp. 1996).

tus based on its charitable activities. Having such status, however, does not fully insulate an organization from taxation. Congress long ago decided that commercial activities conducted by tax-exempt entities that bear no relationship to an organization's charitable purposes should be taxed. Thus, beginning in 1950, Congress has imposed a tax on the "unrelated trade or business" activities of organizations that are otherwise exempt from taxation.³ The rationale for this tax was to ensure that a for-profit business was not put at a disadvantage by a tax-exempt organization that conducted commercial activities in competition with it.⁴ For example, the profits of a business operated by a for-profit entity are reduced by the income tax due on such profits. In contrast, but for Code section 511, a competing business operated by a tax-exempt organization would pay no taxes. Accordingly, such a business would have a higher profit margin, higher cash flow, and would be better able to expand.

Accordingly, Code section 511(a) provides that the "unrelated business taxable income" (hereinafter, UBTI) of certain tax-exempt organizations is taxable at corporate tax rates.⁵ UBTI, in turn, is defined in Code section 512(a) as the "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions . . . which are directly connected with the carrying on of such trade or business . . ."⁶ Note, however, that this general definition of UBTI is subject to a variety of modifications, as discussed below.

"Unrelated trade or business" is defined in Code section 513(a) as "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function" which constitutes the basis for its tax-exempt status.⁷ For example, in the case of a tax-exempt hospital, the net income from the provision of medical services will generally be

3. See Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 994 (1950) (enacting the predecessor to I.R.C. § 511 (West Supp. 1996)).

4. See H.R. REP. NO. 81-2319, at 36-37 (1950) ("The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition."); see also S. REP. NO. 81-2375, at 28-29 (1950).

5. See I.R.C. § 511(a) (West Supp. 1996).

6. *Id.* § 511(a).

7. *Id.* § 513(a). Section 513(a) specifically states that a business activity is not related to an organization's exempt purposes simply because the organization makes use of the business's profits to fund or further the organization's exempt activities. See *id.*

exempt from taxation. However, if that hospital also owned a hotel, the net income from the hotel will generally constitute UBTI, notwithstanding the tax-exempt status of the hospital.⁸

B. Exceptions for Passive Income

Code section 512(b) contains a number of important modifications to the computation of a tax-exempt organization's UBTI. For example, dividends, interest, annuities, royalties, rents, capital gains, and certain other items are excluded from the definition of UBTI.⁹ This exclusion follows from the rationale for imposing a tax on unrelated business activities in the first place. Recall that Congress's concern was to eliminate unfair competition between charitable and for-profit entities operating commercial business activities. However, active competition by a charitable entity with a for-profit business generally does not produce passive income items such as dividends, interest, royalties, rents, and so forth. Such items are typically generated by investment activities and Congress determined that investments by charitable entities did not pose the same unfair competition risk as more active business undertakings.¹⁰

Rents are generally excluded from UBTI, and therefore can be received tax free, only if several conditions are met. The rent exclusion does not apply to the following types of rent: (1) rents under a lease that are attributable to personal property, unless such rent is an incidental amount of the total rents received under the lease, determined at the time the personal property is placed in service;¹¹ (2) rents under a lease that are attributable

8. The balance of this Article uses the example of a hotel operated by a tax-exempt hospital to demonstrate the application of the various principles discussed. It should be noted, however, that if a hotel were operated by a hospital solely for the use by family members of patients (and not for use on a commercial basis by the public as a whole), then such activities might qualify as "substantially related" under I.R.C. § 513(a) (West Supp. 1996). See, e.g., Rev. Rul. 81-28, 1981-1 C.B. 328. Accordingly, such activities would not satisfy the definition of an unrelated trade or business.

Note that the key tax planning concern in such an arrangement is whether the tax-exempt hospital must treat the rent from the hotel as UBTI. However, similar issues would be present if, instead of rent, the arrangement involved payments of interest or royalties, or payments under an annuity.

9. See I.R.C. § 512(b)(1) - (3), (5) (West Supp. 1996).

10. See H. R. REP. NO. 81-2319, at 38 (1950); S. REP. NO. 81-2375, at 30-31 (1950).

11. See I.R.C. § 512(b)(3)(A)(ii) (West Supp. 1996). The applicable regulations provide that the rent attributable to personal property is generally not incidental if it exceeds ten percent of the total rent from all property leased. See Treas. Reg. § 1.512(b)-1(c)(2)(ii)(b) (as amended in 1992).

to real property, if more than half the total rent payable under the lease is attributable to personal property;¹² (3) rents which are computed, in whole or part, by reference to the income or profits derived by any person from the leased property (other than an amount based on a percentage of receipts or sales);¹³ and (4) certain rents from debt-financed property.¹⁴

Moreover, the payment must be "rent" and not a disguised payment for services.¹⁵ While the application of this regulation has not been free from doubt,¹⁶ it does appear clear that amounts paid for the use of hotel rooms or for related services will not constitute "rent" for purposes of Code section 512(b). Accordingly, such amounts will be treated as UBTI.

C. Application of General Principles

The operation of the foregoing rules can be demonstrated in the context of the hotel-owning hospital mentioned earlier. The applicable regulations state that amounts received for occupancy of a hotel room do not constitute "rent" for Code section 512(b) purposes.¹⁷ Accordingly, any income generated by the hotel would most likely constitute UBTI.¹⁸

12. See I.R.C. § 512(b)(3)(B)(i) (West Supp. 1996).

13. See *id.* § 512(b)(3)(B)(ii).

14. See *id.* §§ 512(b)(4), 514.

15. Treas. Reg. § 1.512(b)-1(c)(5) (as amended in 1992) (distinguishing between services such as maid services rendered "primarily for [the occupant's] convenience" and services such as the furnishing of heat and light, the cleaning of shared areas, and the collection of trash, which are "usually or customarily rendered in connection with the rental of rooms or other space for occupancy only").

16. Compare Tech. Adv. Mem. 84-45-005 (July 11, 1984) (because operator/owner of a parking lot did not provide any services, parking deck income constituted rents from real property) with Gen. Couns. Mem. 39,825 (Aug. 17, 1990) (holding that Treas. Reg. § 1.512(b)-1(c)(5) "states categorically that parking lot revenues are not rents from real property").

17. See Treas. Reg. § 1.512(b)-1(c)(5) (as amended in 1992).

18. This conclusion presumes that the operation of a hotel is not related to the hospital's exempt purposes. The operation of a hotel for use by the family members of hospital patients could qualify as substantially related for Code § 513(a) purposes. See *supra* note 8. In a similar vein, it is not unusual for a tax-exempt hospital to own a nearby medical office building and to rent out space in such a building to physicians associated with the hospital. In several rulings, the Internal Revenue Service (hereinafter "IRS") has held that the ownership and operation of a medical office building under such facts is a related function of a hospital and, accordingly, does not generate UBTI. See Rev. Rul. 69-463, 1969-2 C.B. 131; Rev. Rul. 69-464, 1969-2 C.B. 132; Priv. Ltr. Rul. 97-39-042 (June 30, 1997); Priv. Ltr. Rul. 93-15-021 (Jan. 19, 1993); Priv. Ltr. Rul. 88-17-066 (Feb. 2, 1988); Priv. Ltr. Rul. 88-09-092 (Dec. 11, 1987); Priv. Ltr. Rul. 84-52-099 (Sept. 26, 1984). Unless specifically mentioned, it is assumed that the operation of a hotel by a tax-exempt hospital would not qualify as a related function.

In contrast, if the hospital entered into a net lease of the hotel to another party, the result might be significantly different. Assuming the amounts paid by the lessee to the hospital under the net lease constituted rent for Code section 512(b) purposes, the hospital would receive the payments tax-free.¹⁹ By using this structure, the hospital could increase its after-tax return on the hotel.²⁰

Tax practitioners took note of this structure and “improved” it to maximize the after-tax rate of return. Rather than leasing the hotel to an unrelated third party, the hospital creates a wholly owned corporate subsidiary (“Newco”) and enters into a net lease with it. The lease agreement provides for rent payments that are approximately equal to the hotel’s net profit. Under this variation, Newco should end up with little if any taxable income due to the fact that any hotel operating income it earns will be offset by the rent payment.²¹ Moreover, the rent payments from Newco will be received tax free by the hospital to the extent the rent meets the tests of Code section 512(b).

This structure, however, is subject to several important caveats and qualifications. For instance, if the lease provides for rent measured explicitly by the operating income of the hotel, then the rents would appear to violate Code section 512(b)(3)(B)(ii),

19. It is possible that the amount of personal property leased along with the hotel building and the underlying land may be greater than “incidental” (thereby violating I.R.C. § 512(b)(3)(A)(ii) (West Supp. 1996)). If so, the personal property could be purchased by the lessee as part of the transaction. Alternatively, the hospital could sell the personal property to a third party, lease the property back and then sublease the property to the hotel lessee, or have the hotel lessee enter into a lease for the personal property directly with the third party. The IRS has approved a similar arrangement under analogous law. See Priv. Ltr. Rul. 93-40-056 (July 13, 1993).

20. In fact, the rent the hospital could receive from leasing the hotel to a third party would logically be less than the operating income the hotel could generate (otherwise, no one operating the hotel could afford to pay the rent). Because the hotel’s operating income is taxable, while the rental income will be tax free, the after-tax return from renting the hotel is often greater than from operating the hotel. For example, if the hospital could earn \$100 by operating the hotel on its own and the effective tax rate is 40%, then the hospital’s after-tax return would be \$60 (operating income of \$100 less income tax expense of \$40). In contrast, if the hospital could earn \$70 in rents under a net lease arrangement with a third party, the hospital would generally prefer the latter arrangement because it yields a greater after-tax return.

21. Rent is generally deductible by the lessee. If the parties’ assumptions as to the economic performance of the hotel are accurate, then the rent provided for under the lease should be approximately equal to the pre-rent taxable income of the hotel. Newco will obtain a deduction for the rent which will offset the hotel’s taxable income, thereby ensuring that Newco has no taxable income. For this transactional structure to work, it is important for Newco’s taxable income to be zero over the long term because, unlike the hospital, Newco is fully taxable.

which prohibits income-based rents. Accordingly, such rents would not qualify as exempt from UBTI under Code section 512(b)(3)(A).²² In addition, whenever related entities make arrangements at other than fair market value, the IRS may attempt to reallocate income and deductions under Code section 482. As a result, the parties may have to defend the rental rate as being a market rate. This burden is exacerbated if there is a perfect matching of operating income and rent expense.

Finally, the hospital will not obtain tax-free treatment if Newco's separate corporate existence is disregarded and its activities are attributed to the hospital. The IRS's position, as contained in a recent private ruling, is as follows:

For federal income tax purposes, a parent corporation and its subsidiary are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438 (1943); *Britt v. United States*, 431 F.2d 227, 234 (5th Cir. 1970). That is, where a corporation is organized with the bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. *Britt*, *supra* at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. *Krivo Industrial Supply Co. v. National Distillers and Chemical Corp.*, 483 F.2d 1098, 1106 (5th Cir. 1973).²³

Why would the hospital find this arrangement more advantageous than leasing to a true third party? In most cases, a tax-exempt organization that owns a commercial business will not operate that business itself. Instead, it will hire a third-party management company. In the case of a hotel, the parties would enter into an agreement under which the management company assumes the responsibility of operating the hotel, hiring employees, purchasing supplies, handling all billing and payments, and otherwise supervising all aspects of the hotel's operations. In

22. To overcome the income-based rent problem, the lease in such an arrangement will typically contain a rent amount computed as the greater of (1) a fixed dollar rent, or (2) a percentage of certain dollar break points. For example, such a lease might provide for rent equal to the greater of \$100,000 per annum or 10% of gross room revenues.

23. Priv. Ltr. Rul. 98-04-022 (Oct. 23, 1997). See also Gen. Couns. Mem. 39,598 (Jan. 23, 1987); Gen. Couns. Mem. 39,326 (Jan. 17, 1985); Priv. Ltr. Rul. 95-42-045 (Jul. 28, 1995); Priv. Ltr. Rul. 94-47-043 (Aug. 29, 1994).

consideration of these duties, the agreement typically provides for a management fee equal to a fixed percentage of all hotel revenues. Under this arrangement, the management company takes on a variety of obligations, but does not obligate itself to make long-term expenditures.

If a tax-exempt organization desired to enter into a lease of the hotel to a management company, however, the management company would typically be required to take on several additional duties. For example, the management company would be required to pay the rent under the lease, regardless of the actual economic performance of the hotel. Thus, the management company could be saddled with a significant, long-term expense, and the revenues of the hotel may be insufficient to cover it. In addition, in order to forestall any challenge by the IRS that such an arrangement is a sham, it is generally advisable that the management company be sufficiently capitalized so that it can continue to pay the rent even without the revenues of the hotel. Accordingly, the owners of the management company may be required to make a capital contribution.²⁴ Also, in the case of a hotel, there will be significant amounts of personal property. As part of this transaction, the management company may be required to purchase the property from the tax-exempt organization, rather than leasing it.²⁵

Because of the significantly greater risks involved in a leasing arrangement, management companies will typically negotiate a higher fee than would be required under a straight management agreement. For example, under a straight management agreement, the management fee might be set at four or five percent of the hotel's gross receipts. Under a lease arrangement, the management fee might be set at seven percent of gross receipts. Thus, the management fee under a leasing arrangement could be anywhere from forty to seventy-five percent higher than under a straight management agreement. As a result, a tax-exempt organization wishing to minimize expenses and maximize

24. In fact, in most instances the management company forms a single-purpose subsidiary to hold the lease for a single hotel. The management company then transfers assets or cash to the subsidiary in order to establish that the leasing arrangement is bona fide.

25. Recall that under section 512(b)(3)(A)(ii), if more than an incidental portion of the rental payment is attributable to personal property, the rent will be taxable as UBTI. See I.R.C. § 512(b)(3)(A)(ii) (West Supp. 1996). Accordingly, in the case of a business with significant amounts of personal property, it will often be necessary to transfer such property to the management company other than through the lease in order for the rent to qualify under section 512(b). See *id.* § 512(b).

the return on its unrelated business activities will generally prefer to lease to a controlled subsidiary, and enter into a straight management agreement with an outside operator.

D. The First Attempt to Block the Loophole: Old Section 512(b)(13)

An arrangement under which a tax-exempt organization can escape taxation by leasing a commercial business activity to a wholly owned subsidiary would appear to frustrate the purpose behind the UBTI regime. Accordingly, in 1969, Congress enacted the predecessor of what is now Code section 512(b)(13).²⁶

Old section 512(b)(13) applied only if (a) one entity (the "subsidiary") paid interest, annuities, royalties, or rents to another entity (the "parent"), and (b) the parent had control over the subsidiary.²⁷ If applicable, old section 512(b)(13) required the parent to treat as UBTI all or a part of any interest, annuities, royalties, or rents paid by the subsidiary.²⁸ Generally, the portion of such payments treated as UBTI was equal to the ratio of (1) the amount of the subsidiary's UBTI (or what would be its UBTI if the subsidiary were a tax-exempt organization) over (2) the subsidiary's taxable income (or what would be its taxable income if the subsidiary were a taxable organization).²⁹ For these purposes, the determinations of the subsidiary's UBTI and taxable income are made by excluding any amounts paid directly or indirectly to the parent.³⁰

26. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(b), 83 Stat. 487 (1969) (designated as I.R.C. § 512(b)(15)) (redesignated as I.R.C. § 512(b)(13) by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1951(b)(8)(A), 90 Stat. 1520, 1839 (1976)) (amended by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1041(a), 111 Stat. 788, 938 (1997)). For simplicity, a reference to "old" Internal Revenue Code section 512(b)(13) is to the version of that section as it existed immediately prior to its amendment in 1997, and a reference to "new" Internal Revenue Code section 512(b)(13) is to the version of that section as amended by the Taxpayer Relief Act of 1997.

27. Note that old Internal Revenue Code section 512(b)(13) did not apply to dividends. This reflects the fact that the loophole that Congress wanted to close involved the payment of items which were deductible to the payor (i.e., interest, annuities, royalties, and rents).

28. See I.R.C. § 512(b)(13) (1996); see also Treas. Reg. § 1.512(b)-1(l)(1) (as amended in 1992).

29. See I.R.C. § 512(b)(13) (1996); see also Treas. Reg. § 1.512(b)-1(l)(2)(i), -1(l)(3)(i) (as amended in 1992).

30. See I.R.C. § 512(b)(13) (1996). This has the effect of eliminating the tax deductions attributable to such payments.

For example, assume that a tax-exempt hospital (“Parent”) owns all the stock of a taxable corporation (“Sub”).³¹ Among the Parent’s various assets are a commercial hotel and a cafeteria. Under applicable law, the operation of the cafeteria constitutes a related or exempt activity of Parent because, in part, it is provided for use by patients of the hospital, their family members, and Parent’s staff and employees. Parent leases the hotel and the cafeteria to Sub for annual rent of \$100,000. Sub has \$500,000 of taxable income for the year (ignoring the \$100,000 in rent paid to Parent), consisting of \$150,000 in income from the operation of the cafeteria and \$350,000 in income from the operation of the hotel. As noted, the operation of the cafeteria, had it been carried on directly by Parent, would have been treated as a related or exempt activity of Parent. The operation of the hotel, however, would have been treated as an unrelated trade or business of Parent. Parent’s own deductions with respect to the leased property are \$4,000 for the cafeteria and \$16,000 for the hotel. Under these facts, \$56,000 of the rent paid by Sub is taxable to Parent as UBTI, computed as follows:

Sub’s taxable income (ignoring rent paid to Parent)	\$500,000
Less taxable income from hospital cafeteria	\$150,000
Excess taxable income	\$350,000
Ratio of excess taxable income to Sub’s taxable income ((\$350,000 over \$500,000))	70%
Total rent paid to Parent	\$100,000
Total deductions (\$4,000 + \$16,000)	\$20,000
Rentals treated as UBTI (70% of \$100,000)	\$70,000
Less deductions directly connected with such rentals (70% of \$20,000)	\$14,000
Net rentals included by Parent in computing its UBTI	\$56,000

Alternatively, assume the same facts except that Sub’s taxable income (ignoring the rent paid to Parent) is \$300,000, consisting of \$350,000 from the operation of the hotel and a \$50,000 loss from the operation of the cafeteria.³² Sub’s “excess taxable income” is \$300,000 because none of Sub’s taxable income would be excluded from the computation of Parent’s UBTI if received directly by Parent. The ratio of Sub’s “excess taxable income” to its taxable income is therefore one (\$300,000/\$300,000). Accordingly, all the rent received by Parent from

31. See Treas. Reg. § 1.512(b)-1(l)(3)(iii) ex. 1 (as amended in 1992).

32. See Treas. Reg. § 1.512(b)-1(l)(3)(iii) ex. 2 (as amended in 1992).

Sub (\$100,000), and all the deductions directly connected therewith (\$20,000), are included in computing Parent's UBTI:

Sub's taxable income (ignoring rent paid to Parent)	\$300,000
Less taxable income from hospital cafeteria	n/a
Excess taxable income	\$350,000
Ratio of excess taxable income to Sub's taxable income (\$350,000 over \$500,000)	100%
Total rent paid to Parent	\$100,000
Total deductions (\$4,000 + \$16,000)	\$20,000
Rentals treated as UBTI (100% of \$100,000)	\$100,000
Less deductions directly connected with such rentals (100% of \$20,000)	\$20,000
Net rentals included by Parent in computing its UBTI	\$80,000

E. The Control Requirement of Old Section 512(b)(13)

Old section 512(b)(13) only applied if the parent had control over the subsidiary. For these purposes, "control" meant the ownership of stock possessing at least eighty percent of the total combined voting power of all classes of stock entitled to vote and at least eighty percent of the total number of shares of all other classes of stock of such corporation.³³ The definition of control incorporated in old section 512(b)(13), however, only contemplated corporate entities. The applicable regulations go further and contain special rules for determining whether a tax-exempt organization has "control" of a nonstock entity for these purposes:

In the case of a nonstock organization, the term "control" means that at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization. A trustee or director is a representative of an exempt organization if he is a trustee, director, agent, or employee of such exempt organization. A trustee or director is controlled by an exempt organization if such organization has the power to remove such trustee or director and designate a new trustee or director.³⁴

No rules involving constructive ownership, stock attribution, or indirect ownership appear anywhere in either the statute or the applicable regulations. Moreover, as the following

33. Old Internal Revenue Code section 512(b)(13) borrowed the definition of "control" in Internal Revenue Code section 368(c). See I.R.C. § 512(b)(3). See also Treas. Reg. § 1.512(b)-1(f)(4)(i)(a) (as amended in 1992).

34. Treas. Reg. § 1.512(b)-1(f)(4)(i)(b) (as amended in 1992).

paragraphs demonstrate, the IRS historically has applied the control rules as written and has approved arrangements which clearly conflict with the rationale underlying Code section 512(b)(13). Accordingly, old section 512(b)(13) only applied if there was *direct* control.³⁵

As a result, there are two main techniques to “decontrol” a subsidiary. The first technique is to use a second-tier subsidiary, as shown in Diagram 1. In this example, Hospital owns all the stock of SubOne, which in turn owns all the stock of Newco. The hotel is owned by Hospital, but leased to Newco. The rent payments under the lease will not trigger the application of old section 512(b)(13) because Hospital does not directly own any stock of Newco. This result has been approved by the IRS in several rulings.³⁶

At one point, the IRS appeared poised to take a less literal reading of the control requirement.³⁷ However, the IRS’s subsequent rulings followed the technical language of the statute and did not impose look-through or form-over-substance require-

35. The legislative history to new section 512(b)(13) confirms this view. See H.R. REP. NO. 105-220, at 561-62 (1997) (“The control test under section 512(b)(13) does not, however, incorporate any indirect ownership rules.”); see also JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 239 (1997) [hereinafter “Blue Book”].

Recall, however, that if the separate corporate existence of the subsidiary is disregarded, then the activities of the subsidiary would be treated as conducted by the parent and the intercompany payments ignored, with the likely result that the income generated by the subsidiary’s business activities would constitute UBTI to the parent. See *supra* note 24 and accompanying text.

36. See Priv. Ltr. Rul. 95-42-045 (July 28, 1995) (Internal Revenue Code section 512(b)(13) does not apply to payments of royalties, interest, and rent from second-tier subsidiary to Internal Revenue Code section 501(c)(3) parent because latter does not “control” the former); Priv. Ltr. Rul. 95-06-046 (Nov. 17, 1994) (same result involving rental payments from second-tier subsidiary to parent Internal Revenue Code section 501(c)(6) organization); Priv. Ltr. Rul. 90-16-072 (Jan. 24, 1990) (same result involving royalty and interest payments from second-tier subsidiary to parent I.R.C. § 501(c)(6) organization); Tech. Adv. Mem. 90-45-003 (Nov. 9, 1990) (same result involving interest payments from second-tier subsidiary to parent). See also THOMAS J. GALLAGHER, FINANCING REAL ESTATE PROJECTS 382-84 (1995) [hereinafter GALLAGHER, FINANCING REAL ESTATE]; Marlis L. Carson, *Ruling Helps Clarify Service’s Views on Second-Tier Subsidiaries*, 12 EXEMPT ORG. TAX REV. 1145 (Dec. 1995) (addressing Priv. Ltr. Rul. 95-42-045); Marlis L. Carson, *Exploring the UBIT’s Frontier: A National Geographic Production*, TAX NOTES (Dec. 18, 1995) (1432); Thomas J. Gallagher, *The Taxation of Investments by Pension Funds and Other Tax-Exempt Entities*, TAXES 981, 998-9 (Dec. 1989); D. Benson Tesdahl, *Letter Ruling Alert*, 11 EXEMPT ORG. TAX REV. 597 (Mar. 1995) (addressing Priv. Ltr. Rul. 95-06-046 (Nov. 17, 1997)).

37. See Gen. Couns. Mem. 38,878 (July 16, 1982) (use of intermediate subsidiary does not cause de-control of second-tier subsidiary for Internal Revenue Code section 512(b)(13) purposes).

ments. Note, however, that the IRS's approval of this structure is subject to an important caveat as to the corporations involved. Thus, the IRS has predicated its holding in one ruling on a literal reading of the control requirement and on the assumption that both the first-tier and second-tier subsidiaries were organized for valid business purposes and were not agents of the parent corporation.³⁸

The second approach is to intentionally violate the eighty percent ownership requirement. This can be done in a variety of ways. As shown in Diagram 2, one method is to issue preferred stock to a convenience party. In this example, Newco issues two classes of stock: (1) common stock, all of which is issued to Hospital; and (2) nonvoting, nonparticipating, nonconvertible preferred stock, all of which are held by X, a convenience party. Recall that old section 512(b)(13) incorporates the definition of control in Code section 368(c). Under that definition, a corporation must own at least eighty percent of the shares of *all classes* of stock of another corporation. Because Newco has two classes of stock, and Hospital owns no shares of Newco's class of preferred stock, Hospital does not have control of Newco for these purposes. Again, based on its literal reading of the statute, the IRS has approved this structure.³⁹

A variation on this technique (shown in Diagram 3) is for Newco to issue only one class of stock, but to issue twenty-one percent of the shares to a convenience party and the balance to Hospital. As a result, Hospital will own less than eighty percent of the stock of Newco and will fail the control test of Code section 368(c). In some respects, this is a more attractive structure than the use of preferred stock. For the preferred stock approach to work, the preferred stock must be respected. Accordingly, Newco will have to pay timely dividends and otherwise uphold its obligations under the terms of the stock. If the preferred stock is disregarded, or is reclassified as debt, then Hospital will be treated as in control of Newco. In contrast, if part of Newco's stock is held by a convenience party, the IRS could not argue that the entire class of stock should be disregarded. Rather, the IRS would have to argue that some shares should be

38. See Priv. Ltr. Rul. 95-42-045 (July 28, 1995).

39. See Priv. Ltr. Rul. 84-14-001 (no date given). In this ruling, the "convenience party" was an individual who served on the boards of both the parent tax-exempt organization and its subsidiary. See *id.*

ignored, but that shares of the same class held by the tax-exempt parent should be respected.

F. Application of Old Section 512(b)(13) to Partnerships

One of the unresolved issues under old section 512(b)(13) was the treatment of partnerships.⁴⁰ The general rule on the treatment of income earned by a partnership that in turn is owned by a tax-exempt organization is set forth in Code section 512(c)(1):

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, subject to the exceptions, additions, and limitations contained in . . . [Code section 512(b)], 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.⁴¹

Thus, if a tax-exempt organization has an interest in a partnership, the determination of whether the organization's distribution share of partnership income is UBTI is made at the partner (rather than the partnership) level. The applicable tax regulations reiterate this general rule and provide the following additional guidance:

For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in [Treas. Reg.] § 1.512(b)-1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its

40. It is clear from the statute and the applicable regulations that Congress and the IRS never contemplated the use of partnerships in such transactions. For instance, the definition of control in old Internal Revenue Code section 512(b)(13) references the definition in Internal Revenue Code section 368(c). That definition, however, only applies to corporations. In addition, Treasury Regulation section 1.512(b)-1(f)(4) (as amended in 1992) contains definitions of "control" for purposes of old Internal Revenue Code section 512(b)(13) for only two types of entities: "stock corporations" and "nonstock organizations." However, the latter definition appears to have been fashioned solely to address not-for-profit corporations (which frequently do not issue stock), rather than partnerships or other entities.

41. I.R.C. § 512(c)(1) (West Supp. 1996).

share of any dividends received by the partnership from the corporation⁴²

The application of these rules to the arrangement shown in Diagram 4 may be instructive. Assume that a tax-exempt organization, Hospital, and a for-profit entity, X, form a limited partnership, LP. Hospital is a ninety-nine percent limited partner and X is a one percent general partner. LP owns a hotel, which it leases to Newco, a corporation that is wholly owned by LP. Newco will generally not have any tax liability because its operating income should be offset by the rental payments.⁴³ LP will earn rental income from Newco, net of certain ownership expenses. Assume that LP has net rental income of one hundred dollars per year. Of this amount, one dollar is allocable to X. Because X is a for-profit entity, the one dollar is taxable income to X. The remaining ninety-nine dollars is allocable to Hospital.

Recall that old section 512(b)(13) applied only if one "organization" controlled another "organization."⁴⁴ The term "organization" was not defined in the statute. The language used in the applicable tax regulations, however, indicates that the parent or controlling organization must be a tax-exempt entity⁴⁵ and that the subsidiary or controlled organization could be either exempt or taxable.⁴⁶ Based on these regulations, neither Newco or LP could be the controlling organization, because neither is a tax-exempt entity.⁴⁷ Accordingly, only Hospital could be the controlling organization. Newco could not be the controlled organization because old section 512(b)(13) lacked any attribution rules, and Hospital has no direct control over Newco. There-

42. Treas. Reg. § 1.512(c)-1 (adopted in 1958).

43. See *supra* note 22 and accompanying text for discussion of some of the problems raised if rents exactly offset income.

44. See I.R.C. § 512(b)(13) (1996).

45. See Treas. Reg. § 1.512(b)-1(l)(1), -(1)(l)(3)(ii) (as amended in 1992). Specifically, the regulations appear to contemplate that the controlling organization must be listed in Internal Revenue Code section 511 as an organization potentially subject to the tax on UBTI. See I.R.C. § 512(b)(13)(A)(i) (1996) for similar inference.

46. See Treas. Reg. § 1.512(b)-1(l)(2), (3) (as amended in 1992).

47. As a partnership, of course, LP is not subject to income taxation and thus would technically appear to be tax-exempt. However, as note 45, *supra*, indicates, Treasury Regulation section 1.512(b)-1(l)(3)(ii) contemplates that the controlling organization must be listed in Internal Revenue Code section 511. Internal Revenue Code section 511(a)(2) and (b)(2) list the types of entities subject to the tax on UBTI. The list is restricted to organizations exempt under Internal Revenue Code section 501(a); a partnership, however, is not an entity that can qualify for tax-exemption under Internal Revenue Code section 501(a).

fore, old section 512(b)(13) could only apply to the transaction in Diagram 4 if LP qualified as the controlled organization.

By its own terms, however, old section 512(b)(13) only applied to “amounts of interest, annuities, royalties, and rents derived from any organization . . . of which the organization deriving such amounts . . . has control.”⁴⁸ Under old section 512(b)(13), control was defined by reference to Code section 368(c), which measures control by stock ownership.⁴⁹ Even if a liberal reading were permitted so that Code section 368(c) would be deemed to apply to a partnership, old section 512(b)(13) would not apply because LP does not make any rental payments to Hospital.⁵⁰

Arguably, Hospital could be said to “derive” rentals from LP by virtue of the imputation of LP’s rental income to Hospital under general partnership principles.⁵¹ If this were so, then the portion of such rentals treated as taxable would be computed by multiplying the amount of the rental by a ratio.⁵² The numerator of this ratio would be (in this case) the excess of (a) LP’s taxable income over (b) the amount of LP’s taxable income which (if derived by Hospital) would not be UBTI.⁵³ If Hospital, rather than LP, received the rental payments from Newco, however, such payments would be excluded from UBTI under Code section 512(b)(3).⁵⁴ Accordingly, all of LP’s taxable income would be treated as not UBTI if derived by Hospital, and therefore, the numerator of the ratio would be zero. If the numerator were zero, the portion of the rentals treated as taxable would also be zero. In sum, then, old section 512(b)(13) would not appear to be applicable to this arrangement.

Under Code section 512(c), the tax treatment of Hospital’s distributive share of LP’s income is determined by reference to Hospital, not LP. In effect, Code section 512(c) takes an aggre-

48. I.R.C. § 512(b)(13) (1996).

49. The applicable tax regulations extend Internal Revenue Code section 368(c) to “nonstock organizations.” Treas. Reg. § 1.512(b)-1(l)(4) (as amended in 1992).

50. Any payments from LP to Hospital would constitute partnership distributions, not payments of interest, annuities, royalties, or rent. A partnership distribution is generally not taxable to a partner to the extent the partner’s basis is equal to or greater than the distribution. See I.R.C. § 731(a) (West Supp. 1996). Certain exceptions to this general rule can be found at Internal Revenue Code section 731(c).

51. See I.R.C. § 701 (West Supp. 1996).

52. See *id.* § 512(b)(13)(A), (b)(13)(B).

53. See *id.* § 512(b)(13)(A)(i).

54. This result would not be changed by application of old section 512(b)(13); that section would not apply because Hospital would not be deemed to be in control of Newco.

gate rather than an entity approach. Under the aggregate approach, the partnership is ignored and the partners are treated as owning proportionate shares of partnership assets and as directly earning or incurring partnership income and expense.⁵⁵ Arguably, the tax treatment of the rental payments is determined by ignoring the existence of LP and treating Hospital as if it received the rent directly from Newco. However, if LP is ignored and Hospital is treated as receiving the rental payments directly from Newco, then the requirements of old section 512(b)(13) are met. Accordingly, Hospital would be treated as owning ninety-nine percent of Newco and as receiving rental payments from Newco. Therefore, old section 512(b)(13) would require the rental payments to be classified (in whole or part) as UBTI to Hospital.⁵⁶

Because there is so little guidance in this area, it is possible that this analysis is incorrect and that, in the example above, old section 512(b)(13) would not apply.⁵⁷ In an attempt to eliminate the risk created by this uncertainty, tax practitioners often took the conservative approach that the foregoing analysis was correct. Accordingly, if a partnership was involved, the arrangement was often structured so that the partnership owned less than eighty percent of the stock of the lessee/subsidiary (or otherwise lacked control).⁵⁸

II. NEW SECTION 512(b)(13)

New section 512(b)(13), as amended by the Taxpayer Relief Act of 1997,⁵⁹ generally resembles old section 512(b)(13) in that it applies only if (1) a subsidiary pays interest, annuities, royalties, or rents to its parent, and (2) the parent has control over

55. Under the entity theory, partners are not treated as owning the underlying assets of the partnership, and the tax treatment of partnership items is made at the partnership level, without reference to the partners. For a recent discussion of the entity and aggregate theories in a different context, see *P.D.B. Sports, Ltd. v. Commissioner*, 109 T.C. 20 (1997).

56. At least one commentator agrees with this analysis. See GALLAGHER, FINANCING REAL ESTATE *supra* note 36, at 383-84 (example 3).

57. For example, an alternative argument is that old Internal Revenue Code section 512(b)(13) can only be triggered by an actual payment from an entity that is actually controlled by a tax-exempt entity, and that the fiction created for Internal Revenue Code section 512(c) purposes cannot create payments or control where such do not actually exist.

58. As noted, other de-control techniques include the issuance of preferred stock to convenience parties, and the use of second-tier subsidiaries.

59. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1041(a), 111 Stat. 788, 938 (1997).

the subsidiary.⁶⁰ However, three significant changes have been made. First, the mechanism for recharacterizing all or part of the subsidiary's payment as UBTI has been significantly changed.⁶¹ Second, the definition of control is reduced from eighty percent to fifty percent.⁶² Third, the constructive ownership rules of Code section 318 have been incorporated.⁶³

New Code section 512(b)(13) is effective for tax years beginning after August 5, 1997.⁶⁴ However, it does not apply to payments made during the first two taxable years beginning on or after August 5, 1997, provided that such payments are made pursuant to a written binding contract that was in effect on June 8, 1997, and remains in effect at all times thereafter before such payments are made.⁶⁵

A. *Recharacterization of Certain Intercompany Payments*

If new section 512(b)(13) applies, then the parent is required to treat an interest, annuity, royalty, or rent payment from its subsidiary as UBTI to the extent such payment reduces the "net unrelated income" of the subsidiary.⁶⁶ The term "net unrelated income" is defined as: (1) if the subsidiary is not tax-exempt, the portion of such entity's taxable income which would be taxable UBTI if the subsidiary were tax-exempt and had the same exempt purposes as the parent; or (2) if the subsidiary is tax-exempt, the amount of the subsidiary's UBTI.⁶⁷

B. *New Control and Attribution Rules*

Under new Code section 512(b)(13)(D), "control" means: (1) in the case of a corporation, ownership (by vote or value) of more than fifty percent of the stock of such corporation; (2) in

60. As with old section 512(b)(13), the new version does not apply to dividends. See *supra* note 27, and accompanying text.

61. See I.R.C. § 512(b)(13)(A), (B) (West Supp. 1996).

62. See *id.* § 512(b)(13)(D)(i).

63. See *id.* § 512(b)(13)(D)(ii). In addition, Internal Revenue Code section 512(b)(13)(E) authorizes the issuance of regulations to prevent circumvention of these rules by use of related persons.

64. See Taxpayer Relief Act of 1997, P.L. 105-34, § 1041(b)(1), 111 Stat. 788, 938 (1997).

65. See *id.* § 1041(b)(2), 111 Stat. at 938. The Joint Committee on Taxation takes the position that this a technical correction is required to clarify the new law on this issue. See Blue Book, *supra* note 35, at 240 n. 258.

66. See I.R.C. § 512(b)(13)(A) (West Supp. 1996). This rule also applies to the extent such a payment increases any "net unrelated loss" of the subsidiary.

67. See *id.* § 512(b)(13)(B)(i). The term "net unrelated loss" means the net operating loss of the subsidiary, subject to similar adjustments. See *id.* § 512(b)(13)(B)(ii).

the case of a partnership, ownership of more than fifty percent of the profit or capital interests in such partnership; and (3) in any other case, ownership of more than fifty percent of the beneficial interests in the entity.⁶⁸

In applying the new control rules, Code section 512(b)(13)(D) incorporates constructive ownership rules: "Section 318 (relating to constructive ownership of stock) shall apply for purposes of determining ownership of stock in a corporation. Similar principles shall apply for purposes of determining ownership of interests in any other entity."⁶⁹ As will be seen, this small change in the statute largely eliminates the effectiveness of the transactional structures discussed above.

In order to understand the breadth of this stock attribution rule, a review is in order. Code section 318(a) provides the following attribution rules:⁷⁰

- stock owned, directly or indirectly, by or for a partnership is treated as owned proportionately by its partners;⁷¹
- stock owned, directly or indirectly, by or for a partner is treated as owned by the partnership;⁷²
- if fifty percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then such person is treated as owning the proportionate amount of the stock owned, directly or indirectly, by or for such corporation;⁷³ and
- if fifty percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then such corporation is treated as owning the stock owned, directly or indirectly, by or for such person.⁷⁴

In addition to the foregoing, Code section 318(a) also contains special rules requiring the attribution of stock: (1) from a trust to its beneficiaries;⁷⁵ (2) to a trust from its beneficiaries;⁷⁶ (3) from an estate to its beneficiaries;⁷⁷ (4) to an estate from its beneficiaries;⁷⁸ (5) underlying a stock option to the holder of

68. See *id.* § 512(b)(13)(D)(i).

69. *Id.* § 512(b)(13)(D)(ii).

70. See *id.* § 318(b) (contains only cross-references).

71. See *id.* § 318(a)(2)(A).

72. See *id.* § 318(a)(3)(A).

73. See *id.* § 318(a)(2)(C).

74. See *id.* § 318(a)(3)(C).

75. See *id.* § 318(a)(2)(B).

76. See *id.* § 318(a)(3)(B).

77. See *id.* § 318(a)(2)(A).

78. See *id.* § 318(a)(3)(A).

such option;⁷⁹ and (6) to an individual from certain family members.⁸⁰ Finally, Code section 318(a) contains a series of technical “retribution” rules.⁸¹

C. *Application of New Section 512(b)(13) to Existing Structures*

By virtue of the new control and attribution rules, the transactional structures created to take advantage of old Code section 512(b)(13) will no longer provide the same tax advantages. Recall that one such structure, shown in Diagram 1, involves the use of a second-tier subsidiary. Pursuant to Code section 318(a)(2)(C), however, Hospital will be treated as owning all the stock of Newco because Hospital directly owns all the stock of SubOne. Accordingly, Hospital has control over Newco and the rental payments from Newco to Hospital will be recharacterized (in whole or part) as UBTI.

The same result obtains in the second structure discussed above, involving the use of preferred stock.⁸² Under new Code section 512(b)(13)(D)(i), control is measured as fifty percent by vote or value. Because the value of the preferred stock held by X, the convenience party, will generally be minor, the remaining stock held by Hospital will easily meet the fifty percent-by-value requirement. Moreover, because the preferred stock is nonvoting, Hospital will hold all of the voting stock of Newco and therefore will meet the fifty percent-by-vote requirement. Accordingly, Hospital will be treated as having control of Newco for purposes of Code section 512(b)(13).⁸³

Note that the structure shown in Diagram 1 no longer provides the same tax advantages because of the new attribution rules of Code section 512(b)(13). In contrast, the structure shown in Diagram 2 fails because of the new control requirement: control is now measured by either vote or value, rather

79. See *id.* § 318(a)(4).

80. See *id.* § 318(a)(1).

81. See *id.* § 318(a)(5).

82. See *supra*, Diagram 2.

83. See I.R.C. § 512(b)(13). This section will also apply to the variation on this structure involving the issuance of 21% of Newco's common stock to a convenience party. Under the structure shown in Diagram 3, Hospital clearly holds 50% or more of Newco's stock and therefore, meets the control requirement. See *id.* § 512(b)(13)(D)(i)(I).

than under the more rigorous requirements of Code section 368(c).⁸⁴

Even if an arrangement satisfies both the new attribution and control rules, the use of a “convenience” party may be fatal. It appears that any use of related persons as convenience parties will be disallowed under the regulations authorized by Code section 512(b)(13)(E). Because, as noted below, the only structures likely to satisfy the new control and attribution rules are ones in which the tax-exempt organization owns less than half of the lessee, there will be a strong temptation to use convenience parties to hold majority ownership in the lessee. Accordingly, the regulatory authority conferred by Code section 512(b)(13)(E) may assume great importance.⁸⁵

84. Even absent this change, however, it is likely that any use of related persons as convenience parties will be disallowed by the terms of the regulations contemplated under Internal Revenue Code section 512(b)(13)(E).

85. Although under Internal Revenue Code section 512(b)(13)(E) provides that the “Secretary shall prescribe . . .” rules to prevent the avoidance of under Internal Revenue Code section 512(b)(13) through the use of related persons, the IRS has not (as of this writing) promulgated such regulations. Many statutory rules in the Code are prefaced or conditioned with phrases such as “under regulations,” “the Secretary shall prescribe regulations,” “as provided in regulations,” “except to the extent provided in regulations,” “only as provided in regulations,” or some other variant. As the time between the enactment of legislation and the issuance of corresponding regulations lengthens, taxpayers have increasingly challenged the application of statutory rules on the basis that they are not self-executing in the absence of the contemplated regulations.

In *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996), the Tax Court addressed the issue of whether a statute is self-executing in the absence of regulations. The rule in question, Internal Revenue Code section 2663(2) of the generation-skipping transfer statutes, provides that the “Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this chapter, including . . . regulations (consistent with the principles of chapters 11 and 12) providing for the application of this chapter in the case of transferors who are nonresidents not citizens of the United States” The taxpayer argued that this language evidenced the intention of Congress that such regulations were a prerequisite to the imposition of the tax. *Estate of Neumann*, 106 T.C. at 218-19. The government argued that the statute itself imposed the tax and that the quoted language merely evidenced a recognition by Congress that regulations might be needed to fill in some of the details of applying the GST to transfers by nonresident aliens. *See id.* at 219.

In *Neumann*, the Tax Court held, consistent with prior cases, that the statute was self-executing notwithstanding the “shall prescribe regulations” language. *Id.* at 221. In both *H. Enterprises Int’l, Inc. v. Commissioner*, 105 T.C. 71 (1995), and *Occidental Petroleum Corp. v. Commissioner*, 82 T.C. 819 (1984), the court held that, respectively, sections 7701(f) and 58(h), each of which contained the “shall prescribe regulations” language, were self-executing.

Therefore, a tax-exempt organization runs a significant risk if it enters into a transaction with an affiliated person and the IRS later argues that, notwithstanding the absence of regulations, such person was “related” to the organization and therefore could be disregarded for Internal Revenue Code section 512(b)(13) purposes.

D. *Application of New Section 512(b)(13) to Partnerships*

As noted, Code section 512(b)(13) applies to an “organization” which controls another “organization.” It is clear, as with its predecessor, that the subsidiary organization can be taxable or tax-exempt⁸⁶ and that the parent organization must be a tax-exempt organization otherwise subject to the tax on UBTI.⁸⁷

Under the arrangement shown in Diagram 4, Hospital owns a ninety-nine percent interest in LP, which in turn owns all of the stock of Newco. By virtue of Code section 318(c)(2)(A), Hospital will be treated as owning ninety-nine percent of the stock owned by LP. Accordingly, Hospital will be treated as controlling Newco and the rental payments will be treated (in whole or part) as UBTI. As amended, the statute applies to payments received “directly or indirectly” from a controlled entity.⁸⁸ Therefore, the fact that Newco actually makes the payment to LP and not Hospital should not change the conclusion that Code section 512(b)(13) is applicable.⁸⁹ It does, however, suggest that because Hospital “directly or indirectly” receives only ninety-nine percent of the rental payments, Code section 512(b)(13) only applies to that extent.⁹⁰

In the case of the structure shown in Diagram 5, Hospital has only a thirty-three percent interest in LP. Accordingly, Hospital will be treated as owning only thirty-three percent of the stock of Newco,⁹¹ and will not be treated as having control of Newco. Thus, Code section 512(b)(13) would not appear to be applicable in this situation.⁹²

86. Compare I.R.C. § 512(b)(13)(B)(i)(I) (West Supp. 1996) with I.R.C. § 512(b)(13)(B)(i)(II) (West Supp. 1996).

87. See *id.* § 512(b)(13)(B)(i)(I).

88. See *id.* § 512(b)(13)(A).

89. In contrast, old Internal Revenue Code section 512(b)(13) only applied to payments “derived” from a controlled entity. Even if “derived” is given as broad a reading as “directly or indirectly,” the lack of attribution rules meant that old Internal Revenue Code section 512(b)(13) simply could not apply to payments from lower-tier entities.

90. This proportion may differ depending on the terms of the LP partnership agreement.

91. See I.R.C. § 318(a)(2)(A).

92. The IRS could argue that, under Internal Revenue Code section 512(c), the tax treatment of the rental payments must be analyzed under an aggregate theory, but this would not change the result. Under the aggregate theory, LP’s existence would be ignored, and Hospital would be treated as owning 33% of Newco’s stock. Accordingly, Hospital would fail the control requirement of Internal Revenue Code section 512(b)(13) and the rental payments would be excluded from UBTI.

The foregoing analysis is not changed if, in the arrangements shown in Diagrams 4 and 5, the hotel is owned by Hospital and leased to Newco, with rental payments bypassing LP altogether. Under this variation of Diagram 4, Hospital directly receives a payment from Newco and will be treated as in control of Newco under Code section 318(a)(2)(A). Thus, Code section 512(b)(13) applies. Under this variation of Diagram 5, the stock attribution rules will treat Hospital as owning only thirty-three percent of Newco's stock. Accordingly, Code section 512(b)(13) will not apply.⁹³

E. Transactional Structures Under New Code Section 512(b)(13)

As a result of the attribution rules, it now appears that the primary way to avoid Code section 512(b)(13) will be for tax-exempt entities to own (directly or indirectly) less than fifty percent of the lessee/subsidiary. Diagram 5 shows one means of accomplishing this: Newco is owned by LP, but LP has several partners. As discussed above, Hospital will be deemed to own Newco in proportion to its ownership of LP. Accordingly, so long as Hospital owns less than fifty percent of LP, it will not be deemed to control Newco.

A variation is shown in Diagram 6. In this structure, Newco is owned directly by Hospital and two unrelated shareholders. The Hospital leases the hotel to Newco in exchange for rental payments. Because Hospital owns less than fifty percent of Newco, Hospital will not be treated as in control and Code section 512(b)(13) will not apply. However, for this arrangement to be respected, the other shareholders must truly be unrelated and not mere agents of Hospital.⁹⁴ In addition, if the parties contemplate that Newco will never earn profits, it would be difficult to substantiate a business reason for the other shareholders to buy or hold stock in Newco. Therefore, this arrangement is more likely to be respected if the lease is structured to provide some upside potential to Newco.⁹⁵

93. This result is unchanged under an aggregate theory analysis under Internal Revenue Code section 512(c).

94. Under Internal Revenue Code section 512(b)(13)(E), the IRS has specific authority to issue regulations "to prevent avoidance of the purposes of this paragraph through the use of related persons." I.R.C. § 512(b)(13)(E) (West Supp. 1996).

95. Income potential is also likely to resolve some of the problems raised if rents and operating income are approximately equal. See *supra* notes 21-22 and accompanying text.

If an existing activity is currently operated under an arrangement similar to those described in Diagrams 1 through 4, significant restructuring will be necessary to avoid Code section 512(b)(13). Primarily, the tax-exempt owner will have to transfer enough of its shares or partnership interest to unaffiliated parties so that the control requirement is defeated. However, under the intermediate sanctions rules, such a transfer at less than fair market value could trigger large penalties.⁹⁶ Such penalties can only be assessed if the transfer is to a “disqualified person.” Accordingly, the risk of penalties would seem to rule out transfers to convenience parties such as officers or directors.

Even if acceptable buyers can be found, however, the divesting tax-exempt owner will be selling only a partial ownership interest. Accordingly, buyers are likely to offer a discounted price, to reflect marketability and control problems.

III. CONCLUSION

The recent changes to Code section 512(b)(13) should finally close the loophole that Congress intended to close in 1969. It appears that the transactional structures implemented to exploit the loophole⁹⁷ will no longer accomplish the goal of avoiding the payment of taxes. In addition, the amendments eliminate much of the uncertainty with respect to the application of Code section 512(b)(13) in the case of partnerships and make it clear that a partnership will be looked through.

Although some issues remain unresolved, it now appears that the simplest way to avoid the application of Code section 512(b)(13) is by means of a “shared ownership” structure, such as those illustrated in Diagrams 5 and 6. As the transition period for existing arrangements lapses, it is expected that tax-exempt hospitals that operate unrelated business activities will seek to restructure their ownership arrangements. The key to such a restructuring will be to reduce the hospital’s direct or indirect ownership to less than fifty percent. Some possible solutions include selling majority ownership in such businesses to for-profit investors, pooling such activities with other tax-exempt organizations, or bringing in investors who are third par-

96. See I.R.C. § 4958 (West Supp. 1996). Although such penalties cannot be assessed on the exempt organization itself, the risk of such sanctions may deter potential buyers.

97. See *supra* Diagrams 1-3.

ties but have some institutional or philosophical ties to the hospital (i.e., employee trusts, volunteer auxiliaries, and so on).