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UNRELATED BUSINESS TAXABLE INCOME OF CERTAIN TESTAMENTARY CHARITABLE TRUSTS

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Mr. BYRD, from the Committee on Finance, submitted the following

REPORT

[To accompany H. R. 8268]

The Committee on Finance, to whom was referred the bill (H. R. 8268) to amend section 512 of the Internal Revenue Code of 1954, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

By virtue of this act, the Committee on Finance accepts the report of the Committee on Ways and Means, which is as follows:

I. GENERAL STATEMENT

H. R. 8268, as amended by your committee, revises the definition of the term "unrelated business taxable income" contained in the 1954 code. The general effect of this revision is to accord the same tax treatment for income distributed with respect to limited-partnership interests held by certain testamentary charitable trusts that is presently accorded income derived from dividends received by such trusts. The bill, as amended, excludes from the definition of unrelated business taxable income the income derived from a limited-partnership interest only to the extent that the income attributable to such interest is actually distributed. This provision is to be effective with respect to taxable years of trusts beginning after December 31, 1955.

II. REASONS FOR THE BILL

Under existing law, a charitable trust is taxable with respect to its unrelated business income. The Revenue Act of 1950 first made charitable organizations—whether they were tax-exempt organizations or were trusts otherwise entitled to the unlimited deduction for charitable contri-

butions—taxable with respect to their unrelated business income. Such income was made taxable to prevent unfair competition. It was believed that charitable organizations should not be able to use their tax exemption to obtain tax-free profits with which they could expand their business operations, and that they should not be able to use their tax exemption to acquire businesses. Certain types of income, however, were not made subject to tax. In the words of the report of the Committee on Finance:

"Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are passive in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts" (S. Rept. 2375, 81st Cong., 2d sess., pp. 30–31).

No specific exception was made, however, for income received from a partnership interest. Thus, under existing law, income from a partnership interest held by a charitable organization—whether the partnership interest is that of a general partner or that of a limited partner—is unrelated business income except to the extent that the income received by the partnership is specifically excluded as dividends, interest, royalties, and the like. It is the belief of your committee that other income derived from certain limited-partnership interests may also be passive in character and that, to the extent such partnership income is distributed (and subject to other limitations also designed to prevent the forms of abuse which the unrelated business income tax is intended to prevent), such income should be excluded from the tax base.

Where a charitable trust has an interest as a general partner, the income from such interest cannot be considered passive because the charity does not have a mere investment interest in the partnership, but, rather, has the same rights and liabilities with respect to the management, control, and operation of the partnership business that any other partner has. Where, on the other hand, the interest of a charitable trust is solely that of a limited partner in a partnership created under the laws of a State which recognize such interests and which do not permit a limited partner to take part in the control of the business of the partnership and retain liability merely as a limited partner, the income derived from such an interest may be regarded as passive in character and, under the limitations and safeguards provided by this bill, would not be likely to result in serious competition to taxable businesses. Thus, where a limited-partnership interest is held by a charitable trust which is required to distribute currently all of its income exclusively for charitable purposes and which is required ultimately to distribute the trust corpus for such purposes, there is not a problem of unfair competition if the only income from the limited

partnership interest which is excluded from the tax base is the income which is received from the partnership, since the partnership cannot retain the income from such interest without subjecting such income to tax. The charity's tax exemption cannot be used to obtain tax-free profits with which to expand the partnership business operations. Your committee believes that, with the addition of this conduit rule—denying the exclusion to the extent that the partnership income is not actually distributed by the partnership—the income from such an interest is passive in character and does not permit the use of the charitable tax exemption for unfair business competition.

H. R. 8268, as amended, provides additional limitations upon the exclusion. It is provided that, if the charitable trust is a general partner in the partnership (or is liable as a general partner in the partnership), the provision shall not apply for income received from the partnership interest in that year or any subsequent year. This restriction insures that the income received from the charitable trust will be wholly passive in character, and will also prevent manipulations intended to use the charitable trust tax exemption for business purposes. Similarly, the bill applies only to limited-partnership interests acquired by virtue of a will, and, therefore, does not apply, for example, to interests which are purchased by a charitable trust. Thus, in addition to subjecting to tax partnership income that is retained by the partnership, the bill prevents a charitable trust from using its other assets to acquire or enlarge a limited-partnership interest and thereby expand the scope of the partnership business activities. Finally, the bill applies only in the case of a trust created by virtue of the provisions of the will of an individual who died after August 16, 1954, and before January 1, 1957. The bill is effective only with respect to taxable years of trusts which begin after December 31, 1955.

III. EXPLANATION OF THE BILL

Subsection (a) of the bill amends section 512 (b) of the 1954 code by adding at the end thereof a new paragraph (13). The new paragraph (13) is applicable in the case of a trust which meets the following four conditions:

(1) The trust must be created by virtue of the provisions of the will of an individual who died after August 16, 1954, and before January 1, 1957.

(2) The trust must, by virtue of the provisions of such will, be a limited partner in a partnership which is created under the laws of a State providing for the creation of limited partnerships. In addition, under the laws of that State, a limited partner must not have any right to take part in the control of the business of the partnership without becoming liable as a general partner. This condition prevents a charitable trust from qualifying under the new paragraph by acquiring a limited-partnership interest under a general investment power granted to the trustees. For example, if

the terms of the decedent's will do not purport to transfer a limited-partnership interest to a charitable trust created by virtue of the provisions of the decedent's will, but do give broad investment powers to the trustees, a purchase of a limited-partnership interest by the trustees will not qualify the trust for any exclusion under the new paragraph (13), notwithstanding the fact that such an investment is proper or even is specificially contemplated by the trust instrument. However, if the terms of the decedent's will do purport to transfer a limited-partnership interest to the charitable trust, this second condition is complied with (assuming the partnership interest is created under the laws of a State meeting the requirements set forth therein), notwithstanding the fact that the partnership may have to be reconstituted on the decedent's death (as, to convert the decedent's general-partnership interest into that of a limited partner) or that the partnership agreement also makes provision for the transfer of the limited-partnership interest to the charitable trust. Furthermore, if the terms of the will purport to transfer to the charitable trust a limited-partnership interest and, in addition, transfer other assets to the charitable trust, if the trustees acquire an additional interest as a limited partner by the use of the other assets the additional interest does not constitute a limited-partnership interest acquired by virtue of the provisions of the will.

The second condition also limits the exclusion provided by the new paragraph (13) to trusts which are limited partners in a partnership created under the laws of a State which provide for the creation of limited partnerships. For example, the trust may be created under the laws of any State which has adopted the Uniform Limited Partnership Act. Moreover, under this condition, if under State law a limited partner can take part in the control of the business and remain liable merely as a limited partner, the new paragraph (13) will not apply.

(3) The trust may not, either before or during a taxable year of the partnership which ends within or with the taxable year of the trust, be a general partner or be liable as a general partner. This condition prevents a charitable trust from qualifying for the exclusion provided by the new paragraph if the trust has 2 interests in a partnership—1 as a general partner and 1 as a limited partner. Furthermore, if at any time the interest of the trust as a limited partner is converted into that of a general partner, this provision will not apply for that year or for any future year.

(4) The trust must be required, under the terms of the governing instrument and applicable local law, to distribute currently all of its trust income (within the meaning of sec. 643 (b)) exclusively for religious, charitable, scientific, literary, or educational purposes. In addition, the trust must be required ultimately to distribute all of its corpus exclusively for such purposes.

Where all of the four conditions enumerated above are met by a trust, there shall be excluded from the term "unrelated

business taxable income" the trust's share of gross-income of the partnership as such limited partner (and of the partnership deductions directly connected with such income). The trust's share of gross income and deductions shall be determined under section 512 (c), taking into account the exceptions, additions, and limitations contained in section 512 (b) except for those contained in the new paragraph (13) and in paragraph (11). However, if the trust's share of gross income exceeds its share of deductions, the exclusion applies only to the extent that the partnership makes distributions during its taxable year (or on or before the 15th day of the 4th calendar month after the close of such taxable year) which are attributable to such gross income. In determining whether a partnership makes distributions within the requisite period which are attributable to the trust's share of gross income, distributions shall be treated as attributable first to gross income other than the trust's share of gross income excluded under the new paragraph. For example, if a partnership has income which under present law would be excluded from unrelated business taxable income (such as interest or dividends) and in addition has income which would not be so excluded, then, in determining whether and to what extent the trust is taxable, distributions by the partnership will be attributable first to income already exempt. The effect of this rule will be to tax the trust to the extent that the partnership retains any part of the income attributable to the trust's interest in the partnership.

The bill further provides that distributions shall be properly adjusted, under regulations prescribed by the Secretary or his delegate, to the extent necessary to reflect capital contributions to the partnership made by the trust, income of the partnership exempt from tax under the internal-revenue title, and for other items. Thus, for example, if a distribution is made by a partnership to a charitable trust with respect to the limited-partnership interest held by the trust and thereafter the trustees make a capital contribution to the partnership, the amount of the prior distribution may be reduced under this provision. Similarly, a reduction in the amount of a distribution would be made where the partnership received tax-exempt interest and the trust's share of such interest was not distributed by the partnership.

Subsection (b) provides that the amendment made by this bill shall apply to taxable years of trusts beginning after December 31, 1955.

The Treasury Department has raised no objection to the merits of the bill, but is opposed to retroactive legislation.

CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italics; existing law in which no change is proposed is shown in roman):

SECTION 512 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 125. UNRELATED BUSINESS TAXABLE INCOME.

(a) DEFINITION.—The term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the exceptions, additions, and limitations provided in subsection (b). In the case of an organization described in section 511 which is a foreign organization, the unrelated business taxable income shall be its unrelated business taxable income derived from sources within the United States determined under subchapter N (sec. 861 and following, relating to tax based on income from sources within or without the United States).

(b) EXCEPTIONS, ADDITIONS, AND LIMITATIONS.—The exceptions, additions, and limitations applicable in determining unrelated business taxable income are the following:

(1) There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.

(2) There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

(3) There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

(4) Notwithstanding paragraph (3), in the case of a business lease (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514 (a) (1), and there shall be allowed, as a deduction, the amount ascertained under section 514 (a) (2).

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—

(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) property held primarily for sale to customers in the ordinary course of the trade or business.

This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

(6) The net operating loss deduction provided in section 172 shall be allowed, except that—

(A) the net operating loss for any taxable year, the amount of the net operating loss carryback or carryover to any taxable year, and the net operating loss deduction for any taxable year shall be determined under section 172 without taking into account any amount of income or deduction which is excluded under this part in computing the unrelated business taxable income; and

(B) the terms "preceding taxable year" and "preceding taxable years" as used in section 172 shall not include any

taxable year for which the organization was not subject to the provisions of this part.

(7) There shall be excluded all income derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof; and there shall be excluded all deductions directly connected with such income.

(8) In the case of a college, university, or hospital, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(9) In the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(10) In the case of any organization described in section 511 (a), the deduction allowed by section 170 (relating to charitable, etc., contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 5 percent of the unrelated business taxable income computed without the benefit of this paragraph.

(11) In the case of any trust described in section 511 (b), the deduction allowed by section 170 (relating to charitable, etc., contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170 (b) (1) (A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

(12) There shall be allowed a specific deduction of $1,000.

(13) In the case of a trust—

(A) created by virtue of the provisions of the will of an individual who died after August 16, 1954, and before January 1, 1957,

(B) which, by virtue of the provisions of such will, is a limited partner in a partnership created under the laws of a State (i) providing for the creation of limited partnerships, and (ii) under which a limited partner has no right to take part in the control of the business without becoming liable as a general partner,

(C) which, at no time before or during a taxable year of the partnership ending within or with the taxable year of the trust, was (or was liable as) a general partner in such partnership, and

(D) which is required to distribute all of its income (within the meaning of section 643 (b)) currently exclusively for religious, charitable, scientific, literary, or educational purposes, and which is required to distribute all of the corpus exclusively for such purposes,

there shall be excluded its share (determined under subsection (c) without regard to this paragraph and paragraph (11)) of gross income of the partnership as such limited partner and of the partner-

ship deductions directly connected with such income, but, if such share of gross income exceeds such share of deductions, only to the extent that the partnership makes distributions during its taxable year which are attributable to such gross income. For purposes of the preceding sentence (i) any distribution made after the close of a partnership taxable year and on or before the 15th day of the fourth calendar month after the close of such taxable year shall be treated as made on the last day of such taxable year, and (ii) distributions shall be treated as attributable first to gross income other than gross income described in the preceding sentence, and shall be properly adjusted (under regulations prescribed by the Secretary or his delegate) to the extent necessary to reflect capital contributions to the partnership made by the trust, income of the partnership exempt from tax under this title, and other items.

(c) SPECIAL RULES APPLICABLE TO PARTNERSHIPS.—If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (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. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business taxable income shall be based upon the income and deductions of the partnership for any taxable year of the partnership ending within or with the taxable year of the organization.