Rowley United Pension Fund v. Commissioner, 64 T. C. 343, 1975 U. S. Tax Ct. LEXIS 137 (1975)

Indebtedness incurred before March 1, 1954, for leased property remains exempt from unrelated business income tax even if the lease is modified later, but subsequent additions not specified in the original lease do not qualify for the exemption.

Summary

Rowley United Pension Fund leased land to General Telephone Co. in 1953 and constructed a building, financing it with debt. The lease allowed General to request additions after 10 years. In 1964, General requested an addition, leading to a new lease and further debt-financed construction. The Tax Court held that the original building's indebtedness remained exempt from unrelated business income tax under Section 514(g)(5) because it was incurred before March 1, 1954. However, the addition's indebtedness did not qualify for the exemption because it was not necessary to fulfill the terms of the original lease, being contingent on future requests from General.

Facts

Rowley United Pension Fund, an exempt organization, leased land to General Telephone Co. of the Southwest on December 19, 1953. The lease required the Fund to construct a building on the leased land, which was completed and occupied by General in November 1954. The lease included an option for General to request additions to the building after the 10th year of the lease. In 1964, General exercised this option, leading to the construction of an addition financed by new debt. The Fund's income tax return for the taxable year ending August 31, 1970, was audited, and the Commissioner determined a deficiency, arguing that the rental income from both the original building and the addition was subject to unrelated business income tax.

Procedural History

The Commissioner assessed a deficiency of $535,411. 72 against Rowley United Pension Fund for the taxable year ending August 31, 1970. The Fund petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court found that the indebtedness for the original building remained exempt from unrelated business income tax, but the indebtedness for the addition did not qualify for the exemption.

Issue(s)

1. Whether the indebtedness incurred to construct the original building in 1954 remains exempt from unrelated business income tax under Section 514(g)(5) despite the execution of a new lease in 1964?
2. Whether the indebtedness incurred to construct the addition in 1964 qualifies for

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the exemption under Section 514(g)(5) as being necessary to carry out the terms of the original lease?

Holding

1. Yes, because the indebtedness was incurred before March 1, 1954, and the exemption under Section 514(g)(5) is retained throughout the term of the debt, regardless of subsequent lease modifications.
2. No, because the obligation to construct the addition was not fixed before March 1, 1954, and was contingent on General's future request, not necessary to carry out the terms of the original lease.

Court's Reasoning

The court applied Section 514(g)(5), which exempts indebtedness incurred before March 1, 1954, in connection with leased property. The court reasoned that the exemption for the original building's indebtedness was not lost due to the 1964 lease modification, as the exemption applies throughout the debt's term. For the addition, the court held that the indebtedness did not qualify for the exemption because the addition was not specified in the original lease and the obligation to construct it was not fixed before March 1, 1954. The court emphasized that the exemption was intended for concrete commitments made before the effective date of the tax provision, not for contingent future obligations. The court also noted that Congress intended to prevent unfair competition by exempt organizations but also sought to mitigate hardship for trusts with pre-existing commitments.

Practical Implications

This decision clarifies that debt incurred before March 1, 1954, for leased property remains exempt from unrelated business income tax even if the lease is later modified. However, it also limits the scope of the exemption to exclude additions or modifications not specified in the original lease. Attorneys advising exempt organizations should carefully review the terms of leases executed before March 1, 1954, to determine the tax treatment of any subsequent modifications or additions. This case underscores the importance of understanding the timing and nature of obligations under pre-1954 leases when planning future expansions or modifications. It also highlights the potential tax implications of using debt to finance property leased by exempt organizations, particularly in relation to the unrelated business income tax provisions.

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