Elliot Knitwear Profit Sharing Plan v. Commissioner, 71 T. C. 765 (1979)

Income from securities purchased on margin by a qualified profit sharing plan is taxable as unrelated business income to the extent it is debt-financed.

Summary

In Elliot Knitwear Profit Sharing Plan v. Commissioner, the U. S. Tax Court held that income from securities purchased on margin by a qualified profit sharing plan was subject to tax as unrelated business income under Section 511 of the Internal Revenue Code. The trustee had used a margin account to buy securities, which the IRS classified as debt-financed property under Section 514. The court rejected the plan's arguments that such purchases were inherent to its exempt function and that the securities were used in a manner substantially related to its exempt purpose. The decision underscores the broad scope of Section 514, which applies to all income-producing property held with acquisition indebtedness, and its implications for investment strategies within qualified plans.

Facts

The Elliot Knitwear Profit Sharing Plan, a qualified profit sharing plan under Section 401(a) of the Internal Revenue Code, was funded primarily by employer contributions. The trust agreement authorized the trustee to purchase securities on margin. During the taxable year ending April 30, 1972, the trustee did purchase and sell securities using a margin account. The IRS determined that these securities were debt-financed property under Section 514 and that the income derived from them was taxable under Section 511 to the extent of the debt-financing.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the plan's federal income tax for the taxable year ending April 30, 1972. The case was brought before the U. S. Tax Court, where it was fully stipulated under Rule 122 of the Tax Court Rules of Practice and Procedure. The Tax Court issued its decision on February 12, 1979, ruling in favor of the respondent.

Issue(s)

1. Whether income from securities purchased on margin by a qualified profit sharing plan is subject to tax under Section 511 as unrelated business income.

Holding

1. Yes, because the securities are debt-financed property within the meaning of Section 514(b), and the debt-financed portion of the income and gain from those securities is subject to tax under Section 511.

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Court’s Reasoning

The court applied Section 514, which defines “debt-financed property” as property held to produce income and subject to acquisition indebtedness during the taxable year. The plan argued that the margin account was not an acquisition indebtedness because it was inherent in performing its exempt function. However, the court found that incurring debt through margin accounts was not essential for the plan’s operation; it merely affected the return on investment. The court also rejected the plan’s argument that the securities were excluded from the definition of debt-financed property because their use was substantially related to the plan’s exempt function. The court clarified that the property itself, not the income derived from it, must be used in the exempt function to qualify for the exception. The court noted the legislative history of Section 514, which was designed to prevent exempt organizations from engaging in trading activities that leverage their tax-exempt status. The decision was based on the clear language of the statute and its application to all income-producing properties, not just business leases as before the 1969 amendment.

Practical Implications

This decision has significant implications for the investment strategies of qualified profit sharing plans. It confirms that income from debt-financed investments, such as securities purchased on margin, is taxable as unrelated business income. Plan trustees must consider this tax when evaluating the use of margin accounts or other forms of debt financing for investments. The ruling may lead to a reevaluation of investment policies to avoid or minimize the tax impact of debt-financed income. Additionally, this case may influence the structuring of other types of qualified plans, such as pension plans, to ensure compliance with the tax laws governing unrelated business income. Subsequent cases and IRS rulings have continued to reference Elliot Knitwear to clarify the scope of Section 514 and its application to various investment scenarios within exempt organizations.

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