Kern County Electrical Pension Fund v. Commissioner, 96 T. C. 845 (1991)

Interest income from debt-financed property held by a tax-exempt organization is subject to unrelated business income tax.

Summary

Kern County Electrical Pension Fund, an exempt organization, sought to increase its return on certificates of deposit by using them as collateral for loans to invest in new certificates at higher interest rates. The IRS determined that the interest from these new certificates was taxable as income from debt-financed property under Section 514 of the Internal Revenue Code. The Tax Court upheld this determination, ruling that the interest income was subject to the unrelated business income tax (UBIT) because it was derived from debt-financed property, and rejected the Fund's arguments that the income was merely additional interest on the old certificates or payments from securities loans.

Facts

Kern County Electrical Pension Fund (the Fund) held three certificates of deposit with Valley Federal Savings & Loan Association (Valley Federal). Facing rising interest rates, the Fund negotiated with Valley Federal to increase its return without selling the old certificates. Valley Federal proposed that the Fund borrow money using the old certificates as collateral to purchase new certificates at higher interest rates. The Fund implemented this plan, borrowing $740,000 and investing in a new certificate at 11. 75% interest, later exchanging it for another at 17. 5%. The net interest earned from these new certificates was $33,989. 09.

Procedural History

The IRS determined a deficiency in the Fund's income tax for 1980, asserting that the interest from the new certificates was taxable as unrelated business income. The Fund petitioned the United States Tax Court, which upheld the IRS's determination and ruled in favor of the Commissioner.

Issue(s)

1. Whether the interest income from the new certificates is taxable as income from debt-financed property under Section 514 of the Internal Revenue Code?
2. Whether the interest income can be considered merely additional interest on the old certificates and thus exempt from UBIT under Section 512(b)(1)?
3. Whether the interest income can be considered payments with respect to securities loans and thus exempt from UBIT under Section 512(a)(5)?

Holding

1. Yes, because the new certificates were acquired with borrowed funds, making

them debt-financed property under Section 514, and thus the interest income is subject to UBIT.
2. No, because the transaction involved a loan and the purchase of new certificates, not a direct increase in interest on the old certificates, and the Fund must accept the tax consequences of its chosen course of action.
3. No, because the transaction involved pledging the old certificates as collateral for a loan, not lending the certificates themselves, and thus does not qualify as a securities loan under Section 512(a)(5).

Court's Reasoning

The Tax Court applied the plain language of Sections 512 and 514 of the Internal Revenue Code, which define debt-financed property and specify that interest income from such property is included in unrelated business taxable income. The court rejected the Fund's argument that the income was merely additional interest on the old certificates, citing the Supreme Court's decision in Commissioner v. National Alfalfa Dehydrating & Milling Co. , which emphasized that a taxpayer must accept the tax consequences of its actions. The court also found that the transaction did not qualify as a securities loan under Section 512(a)(5), as the old certificates were not lent but pledged as collateral. The court noted that Congress's intent in enacting Section 512(a)(5) was to encourage lending of securities to facilitate market liquidity, not to cover transactions like the one at issue. The court's decision was based on the legal rules applied to the specific facts of the case, without relying on policy considerations or dissenting opinions.

Practical Implications

This decision clarifies that tax-exempt organizations must carefully consider the tax implications of using borrowed funds to acquire income-producing property. The ruling reinforces that income from debt-financed property is subject to UBIT, regardless of the organization's intent or the perceived business purpose of the transaction. Practitioners advising exempt organizations should be cautious about structuring similar transactions, as the court will not look beyond the form of the transaction to the substance if the form falls within the statutory definition of debt-financed property. This case has been cited in subsequent rulings to uphold the taxation of income from debt-financed property, such as in Elliot Knitwear Profit Sharing Plan v. Commissioner and Ocean Cove Corp. Ret. Plan & Trust v. United States. Exempt organizations should be aware that attempting to increase returns through such financial maneuvers may result in unexpected tax liabilities.

