Leila G. Newhall Unitrust v. Commissioner, 105 T. C. 406 (1995)

A charitable remainder unitrust loses its tax-exempt status and is taxable on all its income if it receives any unrelated business taxable income (UBTI).

Summary

In Leila G. Newhall Unitrust v. Commissioner, the Tax Court ruled that the petitioner, a charitable remainder unitrust, was taxable on all its income for the years 1988 and 1989 because it received unrelated business taxable income (UBTI) from its interests in limited partnerships. The court determined that the trust's passive ownership of partnership interests constituted being a "member" of the partnerships, and thus, the income was subject to UBTI rules. Furthermore, the court upheld the regulation that a charitable remainder unitrust loses its tax-exempt status for any year in which it has UBTI, necessitating taxation on its entire income. The decision also confirmed an addition to tax for substantial understatement of income for 1988.

Facts

The Leila G. Newhall Unitrust, a charitable remainder unitrust, received interests in Newhall Land & Farming Co. , Newhall Investment Properties, and Newhall Resources through a corporate liquidation in 1983 and 1985. These interests were publicly traded limited partnerships. For the tax years 1988 and 1989, the trust reported income from these partnerships and claimed it was not subject to unrelated business taxable income (UBTI). The Commissioner disagreed, asserting that the trust was liable for UBTI and, consequently, should be taxed on all its income as a result of losing its tax-exempt status under section 664(c).

Procedural History

The Commissioner determined deficiencies and additions to tax for the trust's 1988 and 1989 tax returns. The trust challenged these determinations and also sought refunds for those years. The Tax Court reviewed the case, focusing on whether the trust received UBTI, the extent of its tax liability, and the applicability of an addition to tax under section 6661 for substantial understatement of income for 1988.

Issue(s)

1. Whether the trust received unrelated business taxable income (UBTI) under section 512(c) from its interests in limited partnerships.
2. If the trust did receive UBTI, whether it is taxable under section 664(c) only to the extent of its UBTI or on its entire net income.
3. Whether the trust is liable for the addition to tax under section 6661 for the taxable year 1988.

Holding

1. Yes, because the trust was a member of the partnerships and the partnerships' income was considered UBTI under section 512(c).
2. No, because the trust, having received UBTI, lost its tax-exempt status under section 664(c) and is taxable on its entire income.
3. Yes, because the trust's understatement of income tax for 1988 exceeded the threshold for a substantial underpayment under section 6661.

Court's Reasoning

The court applied section 512(c) to determine that the trust's passive ownership of limited partnership interests constituted being a "member" of the partnerships, making the income subject to UBTI rules. The court rejected the trust's argument that it was not a member because it did not actively participate in the partnerships, citing Service Bolt & Nut Co. Profit-Sharing Trust v. Commissioner for the broad definition of "member. " The court also upheld the regulation under section 664(c), which states that a charitable remainder unitrust is taxable on all its income if it has any UBTI in a given year. The court found this regulation to be a reasonable interpretation of the statute, supported by legislative history, and consistent with the principle that exemptions are matters of legislative grace. The court also found that the trust's understatement of income for 1988 was substantial under section 6661, leading to an addition to tax.

Practical Implications

This decision underscores the importance for charitable remainder unitrusts to carefully consider the tax implications of investments that may generate unrelated business taxable income. Trusts must be aware that even passive investments in partnerships can lead to the loss of their tax-exempt status, subjecting them to taxation on all their income for the affected years. Legal practitioners advising such trusts should recommend thorough due diligence on potential investments to avoid UBTI and the consequent full taxation. This ruling may also influence future cases involving the tax treatment of charitable trusts and their investments, emphasizing the strict interpretation of the UBTI rules and the conditions for maintaining tax-exempt status.

