THE IMPLICATIONS FOR FARM OWNERSHIP OF THE TAX PREFERRED STATUS OF PENSION TRUST INVESTMENT IN REAL ESTATE

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A qualified retirement trust for pension, profit sharing, or stock bonus plans described in section 401(a) of the Internal Revenue Code is exempt from income tax under section 501(a). The trust is not taxed on passive investment income.[1] The trust is taxed on income derived from a trade or business regularly carried on.[2] Any income derived from a trade or business carried on by an exempt pension trust is, by definition, unrelated to the trust's exempt purpose—the payment of employee benefits.[3] Unrelated business taxable income [UBTI] includes rental income from real and personal property if the lease bases the rental payments on net income or profits generated by the leased assets.[4] UBTI does not include rental income from real and personal property if the lease bases the rental payments on gross production or sales.[5] This latter type of lease arrangement is referred to as a "net lease" because the lessor is guaranteed a specified return or is guaranteed in whole or in part against loss of income.[6] For taxable years ending before 1981, UBTI also included debt-financed income from real

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1. I.R.C. § 512(b).
2. *Id.* § 512(a).
3. *Id.* § 513(b)(2).
4. *Id.* § 512(b)(3)(B)(ii).
5. *Id.* The statutory structure of the unrelated business taxable income rules is difficult to follow. The general rule is that an exempt trust is taxable on business income. *Id.* § 512(a). Rental income is excluded from the business income category. *Id.* § 512(b)(3)(A). Rental income based on net profits is excepted from the § 512(b)(3) exclusion by § 512(b)(3)(B)(ii). Rental income based on gross production is an exception to the § 512(b)(3)(B)(ii) exception and hence comes within the § 512(b)(3)(A) exclusion.
6. *Id.* § 163(d)(1)(B) (pertaining to the limitation on investment debt). A lessor is guaranteed a specified return under a lease that bases the rent on the tenant's gross receipts. *See* Treas. Reg. § 1.856-4(b)(1) (1962); Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b) (1972).

estate investments of pension trusts.[7] Section 110 of the Miscellaneous Revenue Act of 1980 removed such debt-financed income received by exempt pension trusts from tax under the UBTI rules.[8]

Employer contributions to the account of an employee beneficiary of an exempt pension trust are deductible by the employer when made[9] and are not taxable currently to the employee.[10] The trust fund grows both from employer contributions and from the reinvestment of tax-free investment income. The economic benefit of the tax-preferred status of pension fund investment inures to the beneficiary, who is not taxed on the amounts contributed to the fund or on the fund earnings until received upon retirement.[11]

This article examines the implications for farm ownership of the preferential tax treatment of pension trust investment in real estate. The analysis is divided into four parts. Part one summarizes the economic data concerning farm values and returns and pension trust assets in order to place the direct investment activity of pension trusts in perspective. Part two analyzes the economic implications of the preferential treatment of pension trust investment in real estate for speculation in appreciated value farmland. The legislative history of the UBTI rules and the application of the net lease exception to the UBTI rules for farm real estate rental activity carried on by an exempt pension trust are analyzed in Part three. Part four concludes that the tax benefit of exempt status and of debt financing of real estate investment, when combined with the continued inflation of farmland values, creates an incentive for pension funds to shift from direct investment in securities and nonfarm real estate to direct investment in farmland. Were such a shift to occur, it would be a powerful force promoting concentration of farm ownership and separation between land ownership and land use.

I. THE ECONOMIC BACKGROUND

In the past twelve years, the value of farm real estate in the United States has increased 217%; 98% of this gain is attributable to inflation.[12] The result has been to attract nonfarm investors to the farm sector.[13] An aspect of this flow of investment funds to agriculture is the increas-

7. I.R.C. § 514(c).
8. Pub. L. No. 96-605, § 110, 94 Stat. 3521 (1980).
9. I.R.C. § 404(a).
10. *Id.* § 402(a).
11. *Id.*
12. *See* U.S. DEP'T OF AGRICULTURE, *A Time To Choose: Summary Report on the Structure of Agriculture* 51 (1981) (hereinafter cited as *A Time to Choose*); U.S. DEP'T OF AGRICULTURE, *Balance Sheet of the Farming Sector* 7 (Supp. 1980) (hereinafter cited as *Balance Sheet of the Farming Sector*).
13. As used in this article, the term "nonfarm investor" means an investor who does not depend primarily on farm sources for current income.

ing interest shown by tax exempt pension trusts in direct farm investment.[14] This interest has prompted at least one state, Iowa, to bar tax exempt pension trusts from purchasing state farmland.[15] Congress also has evidenced an interest in limiting the ability of exempt pension trusts to compete with tax-free dollars against both nonfarm investors and owner-operators for ownership of scarce agricultural resources.[16] As farmland values (capital gains) have risen above the income generating capacity of the land, it has become increasingly difficult for the operating farmer to purchase a farm or to expand existing holdings out of current earnings. It is feared that if the ranks of potential nonfarm investors are augmented by pension funds trading on the competitive advantage of tax exempt status, the family farmer may indeed be an endangered species.[17]

Historically, the assets of private retirement trusts and noninsured deferred compensation funds have been invested principally in common stocks and debt securities.[18] Direct investment in land has not been a significant component of total fund investment portfolios.[19]

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14. In 1977, Continental Illinois National Bank and Merrill Lynch Hubbard Inc. proposed the creation of a tax exempt collective investment trust fund which would invest solely in United States agricultural land. The proposed declaration of trust filed with the Securities and Exchange Commission stated that the primary investment goal of the fund, called the Ag-Land Fund, was capital appreciation; current cash return was stated to be a secondary objective. Participation in the Fund was to have been limited to tax exempt pension and profit sharing trusts. The initial subscription to the Fund was limited to $50 million. It was contemplated that the Fund assets would be invested in direct fee ownership of farm assets that would be operated as working farms under cropshare leases. The trustees were authorized to use the futures market for hedging the crops to which the Fund would become entitled under the cropshare leases. The bank withdrew the plan and it never actually went into effect. *Hearings Before the Committee on Agriculture*, 95th Cong., 1st Sess. (1977). In 1980, American Agricultural Management Investment Company (AAMI), an Illinois corporation, was organized to locate farm property for tax exempt pension funds and individual investors. Title to the farm property located by AAMI is in the investor. Each investor is required to invest a minimum of $5 million to $10 million in the direct purchase of five to seven farms. It is contemplated that farm management firms will operate the farms through employees or rent them to farmers. The rental agreements would require the tenant farmer to provide equipment and labor and pay a rent of one-half of gross output. *Absentee Ownership of Farmland: Hearings Before the Subcomm. on Family Farms, Rural Development, and Special Studies of the House Comm. on Agriculture*, 96th Cong., 2d Sess. 57-60 (1980) (Statement of Cecil Rusley) (hereinafter cited as *Absentee Ownership of Farmland*). *See* Jansson, *The Hot New Opportunities in Real Estate*, INSTITUTIONAL INVESTOR, June 1980, at 79.

15. IOWA CODE ANN. § 172C.4 (West Supp. 1980-81); *Absentee Ownership of Farmland, supra* note 14, at 5 (Statement of Thomas J. Miller).

16. Hearings before the House Committee on Agriculture were held on the Ag-Land Fund proposal on February 18 and 19, 1977. The transcript of these hearings was not printed. Hearings before the Senate Select Committee on Small Business were held on the AAIM proposal October 8, 1980. The transcript of these hearings also was not printed. Hearings before the House Committee on Agriculture were held on the AAIM proposal on September 22, 1980 in Sioux City, Iowa. The transcript of these hearings was printed for use of the Committee on Agriculture. On November 20, 1980, Senator Baucus introduced S. 3224 to amend I.R.C. § 511 to subject exempt pension trusts to tax on income derived from the rental and sale of farmland and grazing land. 126 CONG. REC. S14783 (daily ed. Nov. 20, 1980) (remarks of Sen. Baucus).

17. *See A Time to Choose, supra* note 12, ch. 4.

18. *See* STATISTICAL BULLETIN, May 1971, at 23; *id.*, May 1980, at 5.

19. *See id.*, May 1971, at 21-23; *id.* May 1980, at 5.

There is evidence that this situation may be changing. At the end of 1970, exempt trust funds were invested as follows:

Assets of Private Noninsured
Pension Funds. 1970[20]

	Book value (millions of dollars)	As a percent of taxable assets	Market value (millions of dollars)
Cash and deposits	$ 1,780	1.9	$ 1,800
U.S. Gov't securities	3,030	3.2	3,000
Bonds	29,210	30.4	24,500
Preferred stock	1,860	1.9	1,700
Common stock	51,080	53.3	64,600
Mortgages	4,240	4.4	3,600
Other assets	4,660	4.9	4,200
Total	$95,850	100.0	$103,500

By 1979, the mix of investment assets in pension fund portfolios had shifted significantly away from common stocks and towards other assets, including real estate. Investment in other assets nearly quadrupled in a period of nine years.

Assets of Private Noninsured
Pension Funds. 1979[21]

	Book value (millions of dollars)	As a percent of total assets	Market value (millions of dollars)
Cash and deposits	$ 8,609	3.9	$ 8,609
U.S. Gov't securities	22,459	10.1	21,516
Bonds	59,537	26.6	51,261
Preferred stock	1,350	0.6	1,099
Common stock	110,943	49.6	122,703
Mortgages	3,091	1.4	2,664
Other assets	17,476	7.8	17,336
Total	$223,465	100.0	$225,188

Although the adverse reaction to the entry of exempt pension trusts into agricultural investment has been strong, it is not clear that the quantity of fund investment at present is a significant market factor.[22] This situation could change, however, in response to the increasing capital gains yield of farm real estate.[23] A comparison of the

20. *Id.*, May 1971, at 23. This includes only those pension funds that invest directly. It does not include pension funds that invest through an insurance company segregated asset account or other financial intermediary.

21. *Id.*, May 1980, at 5-6.

22. *See* Krebs, *Opposition to Farm Investment Firm Mounts*, Ruralamerica, Oct. 1980, at 3; Cavuto, *Brouhaha Continues Over U.S. Farmland*, PENSIONS AND INVESTMENTS, Nov. 10, 1980, at 54; CHICAGO MAGAZINE, 1977, at 228.

23. The United States Department of Agriculture has recently received reports that the trustees of some pension trusts are looking into the purchase of farmland in the South through private investment companies. U.S. DEP'T OF AGRICULTURE, *Farm Real Estate Market Developments* at 3 (Aug. 1980).

average economic return on investment in farmland to that on common stocks explains the relative financial attractiveness of farm investment.[24] Such a comparison explains also why farmland ownership is attractive as a hedge against inflation.

Comparison of Economic Return: farmland and common stock[25]

	Farmland			Common stock		
Years	Average Annual Earnings	Average[26] Capital Gain	Total Economic Return	Average Annual Income	Average[26] Capital Gain	Total Economic Return
1960 - 69	3.46%	4.53%	7.99%	3.19%	6.99%	10.18%
1970 - 78	4.69	11.59	16.28	3.92	0.72	4.64

The recent interest by exempt pension trusts in direct farmland investment has raised the specter of loss of control over land resources by the agricultural sector. The following figures indicate the potential seriousness of the problem. The total value of all farmland in the United States at the end of 1979 was $599.5 billion.[27] The total book value of all private noninsured exempt pension funds at the end of 1979 was $223.5 billion.[28] At any one time, only $8.5 billion of farmland is on the open market.[29] This means that with an investment of only 3.8 percent of total assets, exempt trusts potentially could purchase all of

24. Schertz, *Farming in the United States*, in STRUCTURE ISSUES OF AMERICAN AGRICULTURE 24, 37 (U.S. Dep't of Agriculture, Agriculture Economic Rep. No. 438, Nov. 1979). In the 1970's, the total economic return on investment in farmland (capital gains yield plus income yield) increased relative to that on investment in common stock. *Id.* The value of farm real estate increased by more than $410.4 billion from 1967 through 1979—$8.1 billion in real gain and the rest in inflation. *Balance Sheet of the Farming Sector, supra* note 12, at 6. Total net farm income of farm operators increased (with no part due to inflation) from $14.2 billion in 1970 to $27.9 billion in 1978. *Id.* at 27.

25. Schertz, *supra* note 24, at 37.

26. Generally, changes in capital value reflect changes in the after-tax income yield or earning power of the underlying asset as well as inflation: If r reflects the market interest rate, x the tax rate, and a stream of real income Y_t is expected from a given investment for a period of n years, the after-tax present money value V_x of the investment is:

$$V_x = V(1 - x) = \sum_{t=1}^{n} \frac{Y_t(1 - x)}{(1 + r)^t}$$

Capital gain, that is an increase in V_x, may occur if the tax is reduced or repealed,

$$V = \sum_{t=1}^{n} \frac{Y_t\,(1 - x_o)}{(1 + r)^t} \quad x_o < x$$

or if there is inflation, expressed by a price index P,

$$V_p = \sum_{t=1}^{n} \frac{Y_t P\,(1 - x_o)}{(1 + r)^t}$$

27. *Balance Sheet of the Farming Sector, supra* note 12, at 7.

28. STATISTICAL BULLETIN, May 1980, at 5.

29. *A Time to Choose, supra* note 12, at 76.

the saleable farmland on the market in one year. Although not a likely scenario, it is one that causes concern to defenders of the family farm.

II. THE ECONOMICS OF PREFERENTIAL TAX TREATMENT

The economic benefit of investment in farm assets through an exempt pension trust accrues not to the fund but to the individual beneficiaries. The relevant comparison, therefore, is between a beneficiary of a pension trust that invests the contributions received plus investment earnings in farm assets and the individual who buys farmland directly out of after-tax dollars. The economic benefit consists of two elements: (1) deferral of tax liability on fund earnings until distributed; and (2) increased rate of return on tax exempt investment funds.

Deferral of tax liability affects the rate of expansion of the tax-exempt trust fund. This effect can be seen if the value of an exempt fund at the end of a period of reinvestment of fund earnings is compared to the value of a fund at the end of a period of investment and reinvestment of after-tax income. Consider the case of two individuals, A and B. A's employer in the current taxable year contributes $12,500 to an exempt pension fund, and the fund invests this amount in farm assets. B sets aside $12,500 in before-tax earnings for investment in farm assets and will pay combined federal and state income tax at a 40% rate. Assume that the farm earnings are reinvested each year in the purchase of additional farm assets. Assume further that the annual capital gain rate of return is 12% and the annual income rate of return is 5%. At the end of a 20-year period of accumulation, the value of A's pension fund account is $153,745; the value of B's investment is $85,893. This difference is due to the fact that the 40% tax rate reduces B's initial capital from $12,500 to $7,500 and reduces B's income rate of return from 5% to 3%.

Table A-B

	A	B
Initial capital fund	$ 12,500	$12,500
Reduction for income tax	0	5,000
Net available to invest	12,500	7,500
Income rate of return	5%	5%
Capital gain rate of return	12%	12%
Economic rate of return	17%	17%
Expansion rate	5%	3%
Value of fund after 20 years	$153,745	$85,893
a. Value attributable to earnings reinvested	33,166	13,546
b. Value attributable to capital gain	120,579	72,347

The advantage of deferral in this example is that it turned the investment in farmland which was profitable on an after-tax basis into an even more profitable investment on a tax-free basis. The significance of this is that the higher rate of return was obtained not from the market, but from the tax exemption privilege. This advantage is reduced to some extent by the fact that A would be subject to tax on the full amount of the distribution from the fund if he retired at the end of the 20-year period of accumulation.[30]

For tax years beginning with 1981, the deferral mechanism can be applied to borrowed dollars.[31] The addition of the ingredient of leverage permits the benefit of tax deferral obtained on borrowed money (reduced by the cost of the interest) to be added onto the benefit of tax deferral obtained on amounts contributed to the exempt pension fund. The economic benefit of this double tax benefit is reduced to some extent if the income yield of the debt-financed farm assets is less than the market interest rate for borrowed funds. In such case, the debt, principal, and interest would have to be repaid in part from the income generated by other trust assets, thereby reducing the income yield and hence the expansion rate of these other assets. If the appreciation in value of the debt-financed investment in farm assets during the period of repayment of the debt exceeds the reduction in the combined income rate of return of the debt-financed assets and the other fund investment assets, it would be profitable to finance investment in farm assets out of the income derived from the nonfarm assets.

For example, assume that in the original hypothetical A's exempt pension fund account has a book value of $50,000 and earns an annual return of 10%. Assume also that the capital gain rate of return to these nonfarm assets is zero or negligible. The borrowing rate of interest is 15%. In this circumstance, it would be profitable for the trust to borrow money to buy farm assets for their speculative value, financing the transaction out of income from nonfarm assets.

30. I.R.C. §§ 402, 72. Usually, an employee's tax rate is lower when the funds are received on retirement than when the amounts are contributed to the trust. Further, a deferral of tax is equivalent to the receipt of an interest free loan of the tax deferred for the period of deferral.

31. *Id.* § 514(c)(9).

Nonfarm assets	$ 50,000
Original income rate of return	10%
Income rate of return after payment of interest on farm debt	8.5%
Expansion rate, nonfarm assets	8.5%
Value of nonfarm assets after 20 years attributable to earnings reinvested	
a. 10% expansion rate	$336,375
b. 8.5% expansion rate	255,602
c. the difference	80,773
Debt-financed farm assets	12,500
Income rate of return	5%
Capital gain rate of return	12%
Economic rate of return	17%
Expansion rate, farm assets	0
Value of debt-financed farm assets after 20 years attributable to capital gain	$120,579

In this example, the exempt pension trust gives up $80,773 in nonfarm assets to acquire $118,579 ($120,579 market value minus $12,500 cost basis) in capital gain. The economic benefit to be derived from financing investment in farm assets having a high rate of capital gain yield out of income from nonfarm assets having a low or zero rate of capital gain yield is an incentive for exempt pension trust assets to shift to farm assets. Such a shift would be a powerful force promoting concentration of farm ownership. To illustrate, assume a piece of farmland has a fair market value of $3,000 and a net return per acre of $150 per year—a 5% return. In the original example, A would receive $150; B would have $90 after tax—a 3% return. If common stocks or other alternative investment opportunities for A had an income yield of 4%, it would be economical for A to bid up the price of farmland to $3,750 ($3,750 x .04 = $150), thereby reducing B's after-tax return to 2.4% ($90/$3,750). The likely effect of this bidding process over time would be to decrease further the opportunities for purchasing farmland out of farm earnings.

III. Tax Rules Applicable to the Business and Investment Activities of Exempt Pension Trusts

An exempt pension trust is subject to tax on rental income if the activities carried on with respect to the leased property constitute the conduct of a trade or business regularly carried on by the trust.[32] An exempt pension trust is not regarded as engaged in the conduct of a trade or business if it derives rental income under a lease that bases the

32. *Id.* § 512(a)(1); Treas. Reg. § 1.512(a)-1(a) (1967). The trust also is not taxable on gain from the sale of the assets generating the UBTI, other than inventory assets. I.R.C. § 512(b)(5). For years beginning with 1981, such gains are exempt even if the assets are debt financed. *Id.* § 514(c)(9)(A).

rental payments on gross production or sales.[33] Such a lease is referred to as a net lease.[34] This section examines the policy implications and scope of the net lease rule in the context of direct investment by exempt pension trusts in farm property operated by tenants under a lease with a trust.

A. *Legislative history of the UBTI concept*

Tax exempt status was accorded stock bonus and profit sharing plans in 1921.[35] Tax exempt status was extended to pension trusts in 1926[36] and to common trust funds in 1936.[37] The statutory concepts developed to limit the tax-free income-producing activities of exempt pension trusts originated from a congressional effort to police the business activities of religious, charitable, and educational organizations, exempt from tax since the beginning of the federal income tax system.[38] As early as 1942, the Treasury Department voiced concern over commercial operations carried on directly by charitable, religious, and educational organizations and suggested that they be taxed on the income derived from a trade or business "not necessarily incident to their exempt activities."[39] No action was taken at this time. In 1947, hearings held by the House Ways and Means Committee focused upon commercial operations directly carried on by exempt organizations, in particular transactions involving the purchase and lease of business real estate.[40] The attention of Congress was directed at the charge that exempt organizations were engaged in profit making activities in competition with nonexempt business and investment.[41] Much of the testimony regarding such commercial and investment activity concerned debt-financed purchase-lease transactions by exempt charitable,

33. I.R.C. § 512(b)(3)(B)(ii); Treas. Reg. § 1.856-4(b)(1) (1962); Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b) (1972).

34. *See* I.R.C. § 163(d)(4)(A).

35. Revenue Act of 1921, Pub. L. No. 98, § 219(f), 42 Stat. 247 (1921).

36. Revenue Act of 1926, Pub. L. No. 20, § 219(f), 44 Stat. 33 (1926).

37. Revenue Act of 1936, Pub. L. No. 740 § 169, 49 Stat. 1708 (1936). Prior to 1936, common trust funds were taxed as corporations. Tax exempt status was extended to these funds to enable banks to diversify the investments of many small investors without tax loss. S. REP. No. 2156, 74th Cong., 2d Sess. 20 (1936).

38. Tariff Act of 1913, Pub. L. No. 16, § II(G)(a), 38 Stat. 172 (1913) (current version at I.R.C. § 501(c)(3)), applicable to religious, charitable, and educational organizations, conditions tax exempt status on compliance with two requirements: The organization must be organized exclusively for and operated exclusively for the exempt purpose. The "organized exclusively for" and "operated exclusively for" requirements do not apply to qualified pension trusts. I.R.C. § 401(a) requires that the trust be "for the exclusive benefit" of the employees. This difference is significant and underlies the provision of I.R.C. § 513(b) which defines as an unrelated trade or business any commercial activity carried on by a pension trust.

39. *Revenue Revision of 1942, Vol. I: Hearings before the Comm. on Ways and Means*, 77th Cong., 2d Sess. 89 (1942).

40. *Revenue Revisions—1947-48, Part 5: Hearings before the Comm. on Ways and Means*, 80th Cong., 1st Sess. 3395-3553 (1947).

41. *Id.*

religious, and educational organizations.[42] Congress did not scrutinize the profit making activities of exempt pension trusts during this period.

The congressional hearings resulted in legislation[43] that created two new tax concepts: the taxable feeder organization,[44] and unrelated business taxable income (UBTI) of exempt charitable, religious, and educational organizations (not including churches).[45] The policy underlying the creation of the UBTI concept is stated in the Report of the House Ways and Means Committee:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of these section 101 organizations enables them to use their profits tax-free to expand operations while their competitors can expand only with the profits remaining after taxes.[46]

As originally enacted, both the feeder organization and the UBTI provisions excluded rents from real property (including personal property leased with the real property) from the category of business profits.[47] The House Report describes the scope of the exclusion for rents from real property:

> In general, rents from real property (including personalty leased

42. *Revenue Revision of 1950, Hearings before the Comm. on Ways and Means, Vols. I and II*, 81st Cong., 2d Sess. 18-19; 114; 494-595; 797-798; 2530-2532; 2742-2743 (1950); *Revenue Revision of 1950, Hearings before the Comm. on Finance*, 81st Cong., 2d Sess. 6-7; 216-218; 381-386; 498-519; 525-595; 656-662; 675; 791-792; 848-953 (1950). The principal objection to purchase-lease transactions by exempt § 501(c)(3) organizations was in substance the same as the current objection to farmland investment by exempt pension trusts: The exempt organization could afford to bid up the purchase price of rental property, thereby reducing the percentage yield, because the rental income received by the exempt organization was free of tax.

43. Revenue Act of 1950, Pub. L. No. 814 § 301, 64 Stat. 947 (1950).

44. *Id.* § 301(b), 64 Stat. 953. A feeder organization is a commercial enterprise that pays all of its income to an exempt charity. Before 1950, feeder organizations could avoid payment of federal income tax altogether. *See* C.F. Mueller Co. v. Commissioner, 190 F.2d 120, 123 (3d Cir. 1951) (involving a spaghetti manufacturer that paid all of its profits to New York University without payment of federal income tax).

45. Revenue Act of 1950, Pub. L. No. 814 § 301(a), 64 Stat. 947 (1950). Int. Rev. Code of 1939, ch. 1, § 442, 64 Stat. 948 (now I.R.C. § 512). In the period prior to 1950, two different rules were applied to determine whether commercial activity carried on by an exempt charity was unrelated to the exempt purpose of the organization. Under a "destination of income" test, an organization was exempt if all of its business income was distributed exclusively for charitable purposes, even though the organization's primary or sole activity consisted of carrying on active business operations. *See* Trinidad v. Sagrada Order De Predicadores, 263 U.S. 578, 581-82 (1924); C.F. Mueller Co. v. Commissioner, 190 F.2d 120, 122-23 (3d Cir. 1951). The reasoning underlying this rule in *Mueller* was that "the benefit from revenue is outweighed by the benefit to the general public welfare gained through the encouragement of charity." *Id.* at 122. Other courts focused on the nature of the organization's activities and the source of income in taxing the income of a commercial enterprise distributed to an exempt charity. University Hill Foundation v. Commissioner, 446 F.2d 701, 706 (9th Cir. 1971), *cert. denied*, 405 U.S. 965 (1972); John Danz Charitable Trust v. Commissioner, 231 F.2d 673, 674 (9th Cir. 1955); Ralph H. Eaton Foundation v. Commissioner, 219 F.2d 527, 529 (9th Cir. 1955). Under current law, religious, charitable, educational, and other § 501(c)(3) organizations are subject to tax on business income if it is shown that the business activity is not "substantially related" to the exempt purpose for which the organization was created. Rev. Rul. 70-95, 1970-1 C.B. 137; Treas. Reg. § 1.513-1(d)(1) (1967).

46. H. R. REP. No. 2319, 81st Cong., 2d Sess. 36 (1950).

47. *Id.* at 110.

therewith) and the deductions directly connected therewith are also excluded. . . . The term "rents from real property" does not include income from the operation of a hotel but does include rents derived from a lease of the hotel itself. Similarly, income derived from the operation of a parking lot is not considered "rents from real property." Income received from a business of renting personal property is excluded from unrelated business income only if the personal property is leased with real property.[48]

The Report of the Senate Finance Committee states the reason for the exclusion of rents from real property from the UBTI category:

> 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.[49]

Both the feeder organization and UBTI provisions were extended to employee pension trusts by the Revenue Act of 1954.[50] Since a pension trust must be operated for the exclusive benefit of the employee beneficiaries to qualify for tax exempt status,[51] any business carried on by the trust is by definition "unrelated" to the exempt purpose of the trust. This rule applies to commercial activity carried on directly or through a partnership or other intermediary.[52] The purpose of this rule is explained by the Report of the House Ways and Means Committee: "This provision prevents an employees' trust from advancing the contention that a trade or business in which it engages is not an unrelated trade or business on the ground, for example, that its trust agreement authorizes it to engage in the particular trade or business involved."[53]

As in the case of the 1950 amendments which curbed the tax free, profit making activities of charitable organizations, the impetus to extend the UBTI provisions to qualified trusts was the specter of unfair competition from the business and investment activities of exempt or-

48. *Id.*

49. S. REP. No. 2375, 81st Cong., 2d Sess. 30-31, *reprinted in* [1950] U.S. CODE CONG. & AD. NEWS 3053, 3083. As originally enacted, UBTI included rent derived from leased property purchased out of borrowed funds where the lease term exceeded 5 years, regardless of whether the activities of the exempt organization with respect to the holding of the leased property would otherwise have qualified as investment activity. Revenue Act of 1950, Pub. L. No. 814 § 301(a), 64 Stat. 950. The business lease rental provision was superseded in 1969 by the broader concept of unrelated debt-financed taxable income. I.R.C. § 514.

50. Pub. L. No. 591 §§ 502, 511-514, 68A Stat. 166, 169-176 (1954).

51. I.R.C. § 401(a).

52. *Id.* § 513(b)(2).

53. H. R. REP. No. 1337, 83d Cong., 2d Sess. A170, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4309.

ganizations. The House Report summarizes the policy considerations behind the change:

> Under your committee's bill, qualified pension trusts are treated in the same manner as tax-exempt educational foundations under present law. While the income of these trusts generally will be exempt, a tax is to be imposed on "unrelated business income" derived from the active conduct of a business or from rental income from certain lease arrangements. This is provided in order to place trusts engaging in these activities on the same tax basis as business competitors.[54]

The statutory definition of exempt rental income was amended by the Tax Reform Act of 1969[55] to exclude (*i.e.*, to subject to tax) four different categories of rental income: (1) rents derived from the lease of personal property alone;[56] (2) rents derived from the lease of personal property in conjunction with real property when the rents attributable to the personal property are more than an "incidental amount of the total rents" under the lease;[57] (3) rents derived from the lease of real and personal property when more than 50% of the income under the lease is attributable to the personal property;[58] and (4) rents derived under leases of real or personal property, or both, when the amount of the rentals is determined in whole or in part by the income or profits derived by the lessee from the property leased.[59] Each category of taxable rental income is regarded as income derived from the active conduct of a business.[60]

Rent received under a net income or profits lease (item 4 above) was included within the taxable rental income category at the request of the Treasury Department after a study of the business leasing activities of exempt organizations.[61] This study revealed that the 1950 and 1954 amendments had been only partially successful in preventing tax exempt organizations from taking an unfair competitive advantage of

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54. *Id.* at 45, [1980] U.S. CODE CONG. & AD. NEWS at 4071.

55. Pub. L. No. 91-172 § 121(b)(2)(A), 83 Stat. 538 (1969).

56. I.R.C. § 512(b)(3)(A)(ii).

57. *Id.* The Senate Finance Committee took the position that the rents from personal property are incidental if they comprise less than 10% of the total income from the lease or leases. S. REP. No. 91-552, 91st Cong., 1st Sess. 68-69, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2097. This rule is incorporated in Treas. Reg. § 1.512(b)-1(c)(2)(ii) (1972).

58. I.R.C. § 512(b)(3)(B)(i).

59. *Id.* § 512(b)(3)(B)(ii).

60. *Id.* § 512(a). That is, rents based on a percentage of gross receipts or sales are excluded from the unrelated business income category. Section 512(b)(3)(B)(ii) is patterned after § 856(d)(2)(A), relating to real estate investment trusts. Both sections adopt the rule of the §§ 162 and 1221 cases which include in the business category rental income where "the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of the gross receipts or sales"). Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b)) (1972); *see id.* § 1.856-4(b)(1) (1962).

61. SENATE FINANCE COMM., 91ST CONG., 1ST SESS., TECHNICAL MEMORANDUM OF TREASURY POSITION 18 (Comm. Print 1969).

their exempt status.[62] The Technical Memorandum of the Treasury Department states in relevant part:

> Two amendments to the bill are recommended to insure that income attributable to the active conduct of an unrelated business pays its fair share of tax. First, in order to make clear that only "passive" rental income is excluded from the unrelated business income, section 512(b)(3) should specify that rent from personal property is excluded only when the lease of personal property is incidental to the lease of the realty. The bill should also incorporate the test for "passive" rentals utilized in section 856(d)(1) (dealing with real estate investment trusts). Application of this rule would serve to tax real property rentals in any case where they are measured by reference to the net income from the property, but would exclude rentals based upon a percentage of gross receipts or sales.[63]

The Senate Finance Committee accepted the Treasury recommendations.[64]

The Tax Reform Act of 1969 added the concept of debt-financed taxable income to the number of tools designed to prevent exempt organizations from taking an unfair competitive advantage of their exempt status.[65] This concept, referred to as the "Clay Brown provision",[66] includes within the UBTI rules the income derived from debt-financed property. Section 514(a) defines debt-financed income as that percentage of the income from the property equal to the ratio of the "average acquisition indebtedness" to the average adjusted basis of the property. The term "acquisition indebtedness" is defined in section 514(c) as indebtedness incurred in acquiring or improving the property, incurred prior to acquisition or improvement which would not have been incurred but for the acquisition or improvement, or incurred after acquisition or improvement which would not have been incurred except for the acquisition and improvement.

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62. *Id.* at 17.

63. *Id.* at 18.

64. SENATE FINANCE COMM., 91ST CONG., 1ST SESS. COMPILATION OF DECISIONS REACHED IN EXECUTIVE SESSION 59 (Comm. Print 1969).

65. *See* Pub. L. No. 91-172 § 121(A)(4), 83 Stat. 537 (1969).

66. In Commissioner v. Clay Brown, 380 U.S. 563 (1965), the taxpayer sold all of the stock of a company of which he was president to a tax exempt charitable organization for cash and a non-interest bearing note secured by mortgages and assignments of the company assets. *Id.* at 567. The charity had no obligation to pay taxpayer out of any funds other than the rent paid by the new company. *Id.* The charity liquidated the company and leased the assets to a new corporation wholly owned by the taxpayer's attorneys. *Id.* The taxpayer continued to manage the business. *Id.* The rental payments under the lease were computed as 80% of company operating profits and were applied 90% by the charity to the note. *Id.* After four years of operation, the assets of the company were sold and the proceeds divided between the charity (10%) and the taxpayer (90%). *Id.* at 568. The taxpayer reported the payments remitted out of the profits of the business as capital gain, and the Supreme Court upheld his position. *Id.* at 579. The effect of this arrangement was to permit the charity to acquire ownership of the business without investment of its own funds, and to permit the taxpayer to treat as capital gains the money received from the charity. *See* H. R. REP. No. 91-413 (Part 1), 91st Cong., 1st Sess. 44-46 (1969).

The Miscellaneous Revenue Act of 1980 added section 514(c)(9) to the Code to remove from the UBTI rules debt-financed income from real estate investment by exempt pension trusts.[67] The stated purpose of the exception is to encourage "prudent debt-financed real estate investments" by exempt trusts.[68] A factor also considered by Congress was that of equalizing the position of exempt pension trusts that invest directly in real estate with trusts that invest indirectly through a financial intermediary such as an insurance company segregated asset account.[69] The exception was not extended to debt-financed real estate investment of exempt institutional investors other than pension trusts because the income of these exempt organizations "is not likely to result in a later increase of taxable income of others."[70]

There are five exceptions to the exclusion of debt-financed real estate investment income from the UBTI rules. The exceptions are designed to prevent a return to the kind of tax avoidance abuses covered by the Clay Brown provisions.[71] Thus, the exemption from the debt-financed income rules does not apply if: (1) the acquisition price is not a fixed amount determined as of the date of acquisition;[72] (2) the amount or timing of the debt payments depends on future income derived from the debt-financed property;[73] (3) the property is leased to the seller or a person related to the seller;[74] (4) the property is acquired from a person related to the plan under which the pension fund is formed, or the property is leased to such a related person;[75] or (5) the seller, a person related to the seller, or a person related to the plan provides nonrecourse financing for the transaction, the debt is either subordinate to other indebtedness on the property or bears an interest rate that is less than the rate available from unrelated parties at the time the indebtedness is incurred.[76]

67. Pub. L. No. 96-605 § 110, 94 Stat. 3521, 3525 (1980). The amendment to § 514(c) was added to the Miscellaneous Revenue Act of 1980, H.R. 7956, by the Senate Finance Committee and enacted into law without debate. S. REP. No. 96-1036, 96th Cong., 2d Sess. 1, 2, *reprinted* in [1980] U.S. CODE CONG. & AD. NEWS 7293, 7294. On December 13, 1980, Senator Proxmire proposed that the Senate amendment to H.R. 7956 be amended to provide that the exemption from UBTI for certain debt-financed real estate investments of pension trusts "not serve as a precedent." The amendment was adopted. 126 CONG. REC. S16517 (daily ed. Dec. 13, 1980).

68. S. REP. No. 96-1036, 96th Cong., 2d Sess. 29, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 7293, 7316.

69. *See id.* at 28-29, [1980] U.S. CODE CONG. & AD. NEWS at 7315.

70. *Id.* at 29 n.4, [1980] U.S. CODE CONG. & AD. NEWS at 7316 n.4.

71. *Id.*

72. I.R.C. § 514(c)(9)(B)(i).

73. *Id.* § 514(c)(9)(B)(ii).

74. *Id.* § 514(c)(9)(B)(iii).

75. *Id.* § 514(c)(9)(B)(iv).

76. *Id.* § 514(c)(9)(B)(v).

B. *Application of the UBTI concept to pension trust direct investment in operating farm assets*

Any business activity carried on by an exempt pension trust is by definition "unrelated" to the exempt purpose of the trust.[77] This is true whether the commercial activity is carried on directly by the trust or through a partnership, joint venture, common trust fund, or agent.[78] If an exempt trust engages directly in the conduct of a trade or business, there are two possible tax consequences: The trust can lose its exempt status;[79] or the trust can retain its tax exempt status but pay an ordinary income tax on the unrelated business income derived from its activities.[80]

The consequences of losing tax exempt status are severe. All business and investment income of the fund would be taxable to the trust,[81] and the employer would not be allowed to deduct contributions to the trust unless the employee's rights to the benefits under the trust are vested;[82] if such rights are vested, the employee would be taxed on the employer's contributions to the nonexempt trust in the year deducted by the employer.[83] It is not likely that a pension trust would enter into the business of leasing operating farm properties on a scale that would make the business of farming the primary activity of the trust.[84] Hence,

77. *Id.* § 513(b)(2).

78. *Id.* The fact that farmland owned by an exempt trust is managed by an agent, including an independent farm management company, does not insulate the organization from the activity of carrying on the trade or business of farming. *See* Gilford v. Commissioner, 201 F.2d 735, 736 (2d Cir. 1953); Webster Corp. v. Commissioner, 25 T.C. 55, 61 (1955), *aff'd per curiam*, 240 F.2d 164 (2d Cir. 1957). The exempt fund is engaged in a trade or business through an agent if the activities performed by the agent for the benefit of the fund would, if carried on by the fund, constitute a trade or business. Inez de Amodio, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962).

79. A tax exempt organization will lose its exempt status if its primary activity is the carrying on of a business for profit. Rev. Rul. 55-449, 1955-2 C.B. 599. An organization that has lost its exempt status cannot avoid tax on the profits realized by devoting such profits exclusively to charitable or other exempt purposes. I.R.C. § 502(a); University Hill Foundation v. Commissioner, 446 F.2d 701, 706 (9th Cir. 1971), *cert. denied*, 405 U.S. 965 (1972). *University Hill Foundation* involved an organization engaged in the purchase, sale, and lease of business assets. 446 F.2d at 704. The Circuit Court found that "The deals would have been financially impossible if the Foundation had to pay tax on the 'rents' that it received. Thus, the Foundation was in the business of using its claimed tax exemption to buy used businesses." *Id.* at 705.

80. I.R.C. § 511(a)(1), (2)(A); Treas. Reg. § 1.511-2(a)(1) (1958). A pension trust that loses its exempt status is taxable as a trust under subchapter J, I.R.C. § 641(a). An exempt pension trust that receives UBTI is taxable as a corporation. *Id.* § 511(a)(1).

81. *See* I.R.C. § 641.

82. *See id.* § 404(a)(5).

83. *Id.*

84. For purposes of determining the character of activity by a taxable entity as business or investment, the tax court follows the rule that renting a single piece of residential property constitutes use of the property in a trade or business. Leland Hazard, 7 T.C. 372, 376 (1946); John D. Fackler, 45 B.T.A. 708, 715 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943). The district courts and the courts of appeals have either held to the contrary, Grier v. Commissioner, 120 F. Supp. 395, 398 (1954), *aff'd mem. per curiam*, 218 F.2d 603 (2d Cir. 1955), or have found the carrying on of a trade or business only when the taxpayer's rental property holdings were extensive enough to require considerable activity in addition to the mere holding of the property as an investment—*e.g.*, ad-

loss of tax exempt status is not a realistic limitation on pension trust direct investment in operating farm assets.

This leaves only the UBTI rules as a possible limitation on direct investment by pension trusts in operating farmland. The net lease exception to the UBTI rules severely limits the effectiveness of these rules as applied to the farm rental activity of exempt institutional investors generally and as applied to pension trusts in particular. Under the net lease rule, an exempt pension trust is not regarded as engaged in trade or business with respect to farm property that it owns and leases, either directly or through a management company, if the rental income received: (1) is computed as a share of the gross output raised by the farmer-tenant; or (2) is based upon a percentage of the gross receipts received by the tenant from the sale of farm products raised on the leased land.[85] There are no cases or administrative rulings defining the scope of the net lease exception to the UBTI rules. The regulations under section 512(b)(3)(B)(ii)[86] are not helpful. They refer to the definition of rental income contained in the regulations under section 856(d)(2)(A),[87] which defines real property rental income to be passive investment income if the rent is based on a fixed percentage of total receipts or sales of the lessee. The regulation example covers the lease of a retail store but offers no guidance as to the character of rental income derived under a sharecrop lease of an operating farm.[88] The omission is significant. There is a qualitative difference between a tenant who carries on a trade or business within the space of a leased building and a tenant who carries on the business of farming on leased land. In the farmer-tenant case, the farm operator is necessarily engaged in the business of farming as joint participant with the owner-lessor, whether under a crop-sharing arrangement (net lease) or a profit-sharing lease.[89] In the usual business-tenant relationship, on the

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vertising for tenants, repairing, or performance of other personal services either directly or through an agent. Gilford v. Commissioner, 201 F.2d 735, 736 (2d Cir. 1953). Thus, renting a building under a lease where the taxpayer does not "to any extent, directly or indirectly through agents, have anything at all to do with the management and operation of the property" does not constitute doing business for purposes of qualifying the building as an ordinary asset under the trade or business loss provisions. Union Nat'l Bank of Troy v. United States, 195 F. Supp. 382, 384-85 (N.D.N.Y. 1961). The principles applied in these cases were originally developed at a time when the management of personal investment property was not regarded as the carrying on of a trade or business, with the result that investment income was taxed on a gross basis. Higgins v. Commissioner, 312 U.S. 212, 218 (1941). This line of cases has not been applied in the context of determining the character of real property investment by a tax exempt organization. *See* United States v. Myra Foundation, 382 F.2d 107, *passim.* (8th Cir. 1967); State Nat'l Bank of El Paso v. United States, 509 F.2d 832, *passim.* (5th Cir. 1975).

85. Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b) (1972); *Id.* § 1.856-4(b)(1) (1962).

86. *Id.* § 1.512(b)-1(c)(2)(iii)(b) (1972).

87. *Id.* § 1.856-4(b)(1)(1962).

88. *Id.*

89. A possible exception might be made where the farmland lease provides for a fixed dollar rent. This principle is recognized in Treas. Reg. § 1.175-3 (1957), which defines "the business of

other hand, the lessor of the building does not actively participate in the operation of the business carried on by the tenant unless the lease calls for rent based on a sharing of profits.

Two cases, both decided before the addition of section 512(b)(3)(B)(ii) to the Code, held that an exempt organization was not carrying on the business of farming under a sharecrop lease even though the organization in both cases participated directly in the day-to-day operation of the farm and shared costs with the tenant.[90] *United States v. Myra Foundation*[91] involved an exempt charitable organization that leased ten separate parcels of South Dakota farmland to tenants under leases that provided for a return to Myra of from one-third to one-half of the crops produced on the land.[92] The costs of fertilizer, seed, and weed spray were shared by Myra and the tenants.[93] The day-to-day operations were directed by a farm manager employed by Myra.[94] The court rejected the government's contention that Myra, by sharing costs, was engaged in farming as a partner or joint venturer with its tenants and held that the income received was rent from real property within the meaning of section 512(b)(3) and under state law.[95] The rent did not constitute a return of profits by a person operating the property for the benefit of the tax-exempt organization or a share of the profits retained by such organization as a partner or a joint venturer.[96]

In *State National Bank of El Paso v. U.S.*,[97] the taxpayer was a charitable trust that owned and leased 2,875 acres of irrigated farmland in Texas.[98] Under the lease terms, the trust was to receive as rent nine-tenths of all crops and livestock raised on the property in the form of nine-tenths of the profits from the sale of such crops and livestock by

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farming" for purposes of determining whether the lessor or the tenant is entitled to claim a deduction for soil and water conservation expenditures:

> For the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm.

90. United States v. Myra Foundation, 382 F.2d 107, 111 (8th Cir. 1967); State Nat'l Bank of El Paso v. United States, 509 F.2d 832, 836 (5th Cir. 1975).

91. 382 F.2d 107 (8th Cir. 1967).

92. *Id.* at 108.

93. *Id.* at 111.

94. *Id.*

95. *Id.* As a general rule, the determination of whether or not a taxpayer is engaged in a trade or business for federal income tax purposes is a federal question not controlled by state decisions. Lyeth v. Hoey, 305 U.S. 188, 193 (1938); Pinchot v. Commissioner, 113 F.2d 718, 719 (2d Cir. 1940). The word rent as used in the tax law "should be construed to give a uniform application to a nationwide scheme of taxation. . . ." Webster Corp. v. Commissioner, 25 T.C. 55, 60 (1955), *aff'd per curiam*, 240 F.2d 164 (2d Cir. 1957).

96. 382 F.2d at 111.

97. 509 F.2d 832 (5th Cir. 1975).

98. *Id.* at 833.

the tenant farmer.[99] All costs of the farm operation were borne by the trust.[100] In a later year, the lease was renegotiated to change the nine-tenths share to a 90%-of-the-profits interest for the trust.[101] The government argued that the lease was in fact a management contract because the trust's income depended on the existence of profits and the risk of loss was on the trust.[102] The court of appeals reversed a directed verdict of the trial court for the taxpayer and remanded the case for a new trial on the issue of whether the arrangement was a lease (giving rise to exempt rents) or a management contract (giving rise to unrelated business taxable income).[103] On retrial, the court found that the arrangement was a lease creating a landlord-tenant relationship and that the payments were "rent exempt from taxation *under the pre-1969 I.R.C. §512(b)(3)*."[104] The Solicitor General did not appeal the decision of the trial court on retrial.

Both *Myra Foundation* and *State National Bank of El Paso* represent the law prior to the 1969 amendment that included in UBTI rents based on income or profits derived from the operation of leased property by the tenant. If the question of the tax status of rent received under a cropshare lease were raised under section 513(b)(3)(B)(ii), it is not clear whether the fact alone that the rent is based on gross production or sales would be sufficient to avoid taxable status if there were also substantial entrepreneurial involvement by the lessor and/or if there were cost sharing. Reference to the net lease rules under other code sections where the net lease concept applies indicates that the level of management activity by the lessor is as significant a factor in determining the character of rental income as is the method of computation of the rental payments. For example, under the active conduct of a trade or business rule of section 355(b)(1), the fact that rent under a lease is based on gross production rather than on net profit is merely evidence of the extent of management participation and risk; it is not determinative.[105] The factor of entrepreneurial activity also is relevant

99. *Id.* at 834.
100. *Id.*
101. *Id.* at 834-35.
102. *Id.* at 835.
103. *Id.* at 836-37. The court indicated that a cropsharing arrangement might create: (1) the relationship of employer and employee, with the latter's wages paid in crops; (2) the relationship of landlord and tenant, with the farmer's rent being paid in crops; or (3) a partnership between the parties, with the crops divided between them as the profits of a business, depending on the intent of the parties or provisions of local property law. *Id.*
104. 75-2 U.S.T.C. ¶ 9868 at 88,774 (W.D. Tex. 1975) (emphasis added).
105. I.R.C. § 355 extends the nonrecognition-of-gain benefits to the transfer of assets if the assets transferred constitute the active conduct of a trade or business. Treas. Reg. § 1.355-1(c)(1) (1955) excludes from the active business category "The holding for investment purposes of . . . land or other property, including casual sales thereof. . . ." The only example given in the regulations is of unrented, vacant land held for appreciation in value. *Id.* § 1.355-1(d)(ex.6). Under the § 355 active-conduct-of-a-trade-or-business test, the distinction between business and invest-

to determine the character of rental income received by a subchapter S corporation,[106] by a personal holding company,[107] or by a foreign personal holding company.[108] In all of these cases, the rental of farmland under a sharecrop lease gives rise to business income if the lessor participates to a material degree in the production of farm commodities, either through physical work or by participation in management decisions. On the other hand, under the test for section 856(d) pertaining to rental income of a real estate investment trust, the level of business activity of the lessor with respect to the leased property does not appear to be a significant factor.[109] The section 856(d) rules apply under sec-

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ment activity with respect to leased real property is the presence (or absence) of entrepreneurial activity, not the factor of whether the rent is based on gross output or net profit. The entrepreneurial activity test supports making a distinction between the activity of managing and operating farm property through tenants and the activity of leasing commercial real estate under a long-term lease. Thus, a bank operating farm properties through tenants is actively engaged in both the banking business and the business of farming. Rev. Rul. 56-555, 1956-2 C.B. 210 (some of the farmland was rented under cropshare leases); Rev. Rul. 56-557, 1956-2 C.B. 199; Rev. Rul. 73-234, 1973-1 C.B. 180 (some of the farming operations were carried on by tenants acting as independent contractors). On the other hand, a subsidiary corporation whose sole activity is leasing business property to its parent corporation is not engaged in the active conduct of a trade or business. Rafferty v. Commissioner, 452 F.2d 767, 772-73 (1st Cir. 1972); *see* Rev. Rul. 56-266, 1956-1 C.B. 184; Rev. Rul. 68-284, 1968-1 C.B. 143.

106. An election by a corporation to be taxed under the provisions of subchapter S is automatically terminated if more than 20% of the corporation's gross receipts are from rents and other passive income. I.R.C. § 1372(e)(5)(A). For this purpose, the regulations define "rents" to include amounts received "for the use of, or right to use property." Treas. Reg. § 1.1372-4(b)(5)(vi)(1959). The rental of farmland under a sharecrop lease where the rent is computed as a percentage of gross output and the tenant pays all expenses and bears the risk of loss constitutes investment and not business activity for subchapter S purposes if the lessor takes no part in the management of the farm operation, either directly or through an agent. Gladys M. Kennedy, 33 T.C.M. 655, 658-59 (1974). However, if the shareholder "participates to a material degree" in the production of farm commodities through physical work or management decisions or a combination of both, the rental activity constitutes a business and not an investment activity for subchapter S purposes. Rev. Rul. 61-112, 1961-1 C.B. 399.

107. I.R.C. §§ 541, 543(a)(2)(A); Treas. Reg. § 1.541-1 (1958). A corporation is taxable as a personal holding company if at least 60% of adjusted ordinary gross income is passive investment income. I.R.C. §§ 542(a)(1), 543(a). Rents qualify as investment income unless they constitute 50% or more of the adjusted ordinary income plus dividends. *Id.* § 543(a)(2). In Commissioner v. Webster Corp., 25 T.C. 55 (1955), *aff'd per curiam*, 240 F.2d 164 (2d Cir. 1957), a personal holding company purchased several farms in Iowa in order "to obtain an appreciation in the asset values of the farms by increasing the productivity of the soil and improving the buildings." 25 T.C. at 57. The farms, which were in a run-down condition, were operated through a farm management firm under sharecrop leases. *Id.* The corporation, acting through the management firm, exercised "tight control" over crop plantings in order to prevent a further deterioration. *Id.* The issue was whether the amounts received under the sharecrop leases were investment rental income or business income for purposes of fixing liability for personal holding company surtaxes. *Id.* at 620. Because the corporation took an active part in the operation of the farms, amounts received under the sharecrop lease qualified as business profits and not rental income. *Id.* at 61.

108. A United States shareholder is taxed on both the distributed and undistributed income of a foreign personal holding company. I.R.C. § 551; Treas. Reg. § 1.551-1 (1958). Rents qualify as investment income unless they constitute 50% or more of gross income. I.R.C. § 553(a)(7). The § 543 definition of rents applies also for purposes of determining the character of income received by a foreign personal holding company. Treas. Reg. § 1.553-1 (1958).

109. To qualify as a real estate investment trust, the income of the trust must be derived 90% from investment assets. I.R.C. § 856(c)(2)(C). Rent from real property does not include rent based on a percentage of profits; it does include rents based on gross production. *Id.* § 856(d)(2)(A).

tion 513(b).[110] It is not clear that cases arising under other code sections have significant precedential value under section 513(b).

The difficulty of determining the scope of the net lease concept for purposes of fixing the character of farmland rental income raises the question of whether the concept is a valid one in the context of farmland rental. There is as effective a sharing of risk and gain under a farm lease where the rental income is based on gross production and the lease provides for cost sharing as there is under a profit-sharing lease. Lessors of farm property effectively manage the business of farming carried on by the tenants whether they hire a farm management company to supervise the day-to-day operations of the farm, rent to a skilled tenant who needs little supervision, or undertake the job of supervision directly. The criteria relied on by the courts are therefore beside the point. When the purpose of the distinction between investment and business activity is to fix the character of rental income as taxable or exempt, rental income derived from the lease of farm assets should be included in the UBTI category without regard either to the method of computation of the rental income or the degree of entrepreneurial activity of the lessor.[111]

C. *Application of the UBTI concept to exempt pension trust investment in operating farm assets through an intermediary*

There are several ways in which an exempt pension trust can invest in farm assets through an intermediary that is engaged in the business of farming. The trust can invest in a general partnership, in a limited partnership, in a common trust fund, or in a real estate investment trust. It can also invest in operating farm assets through a feeder organization. Investment through an intermediary raises the question of whether the profits from the farming operation carried on by the intermediary retain their character as business income when distributed or distributable to the exempt pension trust. If the profits retain their character as business income, they are taxable to the fund as UBTI by definition.[112] If the profits qualify as a return on investment when distributed to the fund, they are exempt from tax.[113] The rate of tax appli-

110. Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b) (1972) refers to Treas. Reg. § 1.856-4(b)(1) (1968).

111. This would include rent based on a fixed dollar amount without reference either to profit or production. The modifications to the § 512(a) definition of UBTI set forth in § 512(b) have so cluttered the section that it is difficult to know where to place further amendments. Although the treatment of capital gains from the sale of farmland is outside the scope of this article, any amendment to the UBTI rules to include farm rental income should also include gain or loss from the sale, exchange, or other disposition of farmland. The approach of S. 3224 is to add a new paragraph 16 to the existing 15 paragraphs of subsection (b) which, in turn, modify the 5 paragraphs of subsection (a) of § 512.

112. I.R.C. § 512(a).

113. *Id.* § 512(b)(1).

cable to UBTI received by an exempt pension trust is the corporate rate of section 11.[114]

The rules governing the tax status of exempt pension trust investment in operating farm assets through an intermediary are summarized in paragraphs (1) through (4).

(1) Farming Operations Carried on Through a Partnership

Under section 512(c), if a partnership of which an exempt trust is a member carries on a trade or business that would be an unrelated trade or business if carried on directly by the exempt trust, the trust must report as UBTI its distributable share of the partnership earnings.[115] For taxable years beginning after 1980, the exempt fund is not taxable on the profits from farm operations carried on with respect to farmland purchased by the partnership for cash and a mortgage, or purchased subject to a mortgage.[116] The same rule applies to investment in a limited partnership interest.[117] The character of the income as UBTI in the hands of the partnership carries over to the exempt fund.[118]

(2) Farming Operations Carried on Through a Common Trust Fund

A common trust fund is a fund maintained by a bank exclusively for the investment of monies contributed by the bank in its capacity as a fiduciary.[119] The fund must conduct its investment activities in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency.[120] A common trust fund that satisfies these requirements is treated as a conduit for tax purposes;[121] it is not an exempt organization under section 501(a).[122] A common trust fund that does not satisfy the statutory requirements is taxable as an association.[123] The tax exempt status of a qualified pension fund is not affected if it pools its investment funds in a common trust fund.[124] An exempt pension fund's proportionate share of the income of a common trust comes within the section

114. *Id.* § 511(a)(1). The minimum tax on tax preference income also applies to tax preference items taxable as UBTI. *Id.* § 511(d)(1).
115. *Id.* § 513(b).
116. *Id.* § 514(c)(9).
117. Rev. Rul. 79-222, 1979-2 C.B. 236.
118. *Id.*
119. I.R.C. § 584(a)(1).
120. *Id.* § 584(a)(2).
121. *Id.* § 584(b).
122. Only taxable entities such as corporations and trusts can be exempt from tax under § 501(a). *Id.* § 501(c)-(f).
123. Treas. Reg. §§ 301.7701-2, 301.7701-3 (1960).
124. Rev. Rul. 56-276, 1956-1 C.B. 206.

512(a)(1) definition of UBTI if it would be UBTI if received directly by the exempt trust.[125] Applied to investment in farmland, this means that rental income received by a common trust fund under a net lease of farmland would be treated as exempt investment income to an exempt pension trust member. Business profits received by a common trust fund from the active management and operation of farm property owned by the common trust fund would be taxable UBTI to the exempt pension trust member.

(3) Farming Operations Carried on Through a Real Estate Investment Trust

A real estate investment trust (REIT) may be organized as a corporation, a trust, or an association, provided it has all of the tax attributes of a corporation under the association rules.[126] If the REIT distributes at least 90% of its taxable income for the taxable year, it is taxable as a corporation on its undistributed income other than capital gains.[127] Undistributed capital gain income is taxable at the alternative capital gain rate of 28% if this results in a lower tax.[128] Distributed income is taxed only once—to the shareholders when received.[129] REIT distributions out of earnings and profits are taxable as dividends, which means they are treated as exempt investment income in the hands of an exempt pension fund.[130] A REIT, however, is not a likely vehicle through which exempt pension trusts can enter into the management and operation of farm properties because rental income received under a profit-sharing lease would not qualify as investment income in the hands of the REIT.[131]

(4) Farming Operations Carried on Through a Feeder Organization

An exempt pension trust can invest in a farm management com-

125. Proposed Treas. Reg. § 1.584-2(c)(4)(vi), 45 Fed. Reg. 62848 (Sep. 22, 1980). In Private Let. Rul. No. 7840039, July 1978, the I.R.S. cited Rev. Rul. 67-301, 1967-2 C.B. 146 "as precluding the position that the character and source of ordinary net income or ordinary net loss of a common trust fund are passed through to a participating exempt trust." In Private Let. Rul. No. 7848051, August 1978, the I.R.S. interpreted Rev. Rul. 67-301 to mean that income from debt-financed property which would be UBTI if received directly by an exempt pension trust was not UBTI if derived from debt-financed investment made by a common trust fund. Rev. Rul. 67-301 states only that an exempt pension trust's "proportionate share of the income of a common trust fund is not unrelated taxable business income in the hands of the employees' trust." The ruling contains no facts concerning the character of the income earned by the common trust fund, whether investment income, business profits, income from debt-financed property, or capital gain income.

126. I.R.C. § 856(a); Treas. Reg. § 301.7701-2; 301.7701-3 (1960).

127. I.R.C. § 857(b).

128. *Id.* § 857(b)(3).

129. *Id.* § 857(b).

130. Rev. Rul, 66-106, 1966-1 C.B. 151.

131. I.R.C. § 856(d)(2)(A); Treas. Reg. § 1.856-4(b)(1) (1962).

pany taxable as a feeder organization without affecting its tax exempt status.[132] Profits earned by the feeder organization are taxable to the organization at corporate rates,[133] but are not taxed a second time when distributed as dividends to the exempt pension fund.[134] Taxable profits of a feeder organization of an exempt pension trust include any income which would be taxed as UBTI if earned directly by the exempt pension trust; it therefore does not include rental income derived from a net lease of real estate.[135]

IV. CONCLUSION

The principal purpose of this article has been to point out the implications for farm ownership of the tax preferred status of pension trust investment in real estate. While exempt pension trusts do not at present constitute a significant presence in the farmland market, this situation could change in response both to tax rules that favor saving for retirement through exempt pension trusts and to rising farmland values. The UBTI rules as presently structured would not prevent exempt pension trusts from entering the market for farmland and competing for scarce farm resources with tax free dollars. The net lease exception to the UBTI rules probably would exempt from tax farm rental income received under a cropsharing lease even if there were management participation and cost sharing by the lessor-trust. The recently enacted limitation on the application of the debt-financed income rules to pension trust real estate investment is a further incentive for pension trusts to shift funds out of nonfarm investments (both securities and real estate) having a low capital gain yield and into farmland. Over time, a concentration of farm assets in the hands of exempt pension trusts would result in a significant redistribution of farm income away from the operating farmer (both owner-operator and tenant) to the retired beneficiaries of pension trusts. The implications of such a change are far reaching, but outside the scope of this article.

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132. *See* Rev. Rul. 71-529, 1971-2 C.B. 234 (organization providing investment management services to other exempt organizations at substantially below cost is exempt). *But see* Rev. Rul. 72-369, 1972-2 C.B. 245; Rev. Rul. 69-528, 1969-2 C.B. 127; B.S.W. Group, Inc., 70 T.C. 352, 358 (1978).

133. I.R.C. § 502(a).

134. *Id.* § 512(b)(1).

135. *Id.* § 502(b)(1); Treas. Reg. § 1.502-1(b) (1958).