April 9, 2011

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on the Scope of Section 514 of the Internal Revenue Code

Dear Commissioner Shulman:

Enclosed are comments on the scope of section 514 of the Internal Revenue Code. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William M. Paul
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
Sarah Hall Ingram, Commissioner (Tax-Exempt & Government Entities), Internal Revenue Service
Lois G. Lerner, Director (Exempt Organizations), Internal Revenue Service
Holly O. Paz, Acting Director (Exempt Organizations - Rulings and Agreements), Internal Revenue Service
Lisa M. Zarlenaga, Deputy Tax Legislative Counsel (Regulatory Affairs), Department of the Treasury
Ruth M. Madrigal, Attorney Advisor (Tax Policy), Department of the Treasury
These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Robert A. Wexler of the Committee on Exempt Organizations of the Section of Taxation. Substantive contributions were made by Suzanne Ross McDowell, David Shevlin, and Richard Sevcik. The Comments were reviewed by Fredrick J. Gerhart, Committee Chair. The Comments were further reviewed by James K. Hasson of the Section’s Committee on Government Submissions, and Michael A. Clark, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: April 9, 2012
EXECUTIVE SUMMARY

During the Exempt Organizations Committee’s annual courtesy visits to the Internal Revenue Service (the “Service”) and the Department of the Treasury (the “Treasury”), representatives of the Committee discussed with representatives of both the Service and the Treasury the application of section 514 to situations where exempt organizations borrow funds to make charitable grants, support charitable programs, or pay administrative expenses. Following one of these meetings, the Service asked for written comments on the subject, including examples illustrating how we think section 514 should apply in those situations.

Although tax-exempt organizations are generally exempt from federal income tax, they are subject to a tax on their unrelated business income. Items of passive investment income, including dividends, interest and capitals gains, are generally exempt from this tax unless the property generating the passive income is “debt-financed” within the meaning of section 514. Property is “debt-financed” when “acquisition indebtedness” is incurred to acquire or improve it.

These Comments focus on when a borrowing should be treated as “acquisition indebtedness” with respect to passive investment assets. Issues arise when an exempt organization borrows to fund its exempt activities while at the same time, on its behalf, its investment advisors are buying and selling investments that produce passive investment income. The Service has in the past expressed informal concern that a borrowing to fund exempt activities is “acquisition indebtedness” attributable to investment assets when the debt, even though motivated by the needs of the organization’s charitable programs, is incurred contemporaneously with the purchase of investment assets.

Although the Code and the Regulations provide guidance on when a debt should be treated as “acquisition indebtedness,” the existing guidance does not address common situations faced by tax-exempt organizations. This lack of guidance has persisted for many years, but the recent “Great Recession” has made the need for additional guidance much greater. We believe the four new examples recommended in these Comments are entirely consistent with section 514 and the existing Regulations. Our new examples are intended to supplement, not replace, the examples already in the Regulations.4

1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated, and references to “Regulations” are to the Treasury Regulations promulgated thereunder.
3 I.R.C. §§ 511-515.
4 The proposed examples are also consistent with the conclusions reached in several letter rulings dealing with pension plans. See e.g., PLR 8721107 (Feb. 27, 1987); PLR 9644063 (Nov. 1, 1996); PLR 200010061 (Dec. 17, 1999).
The four examples that we recommend deal with the application of section 514 to situations in which an exempt organization makes a decision to borrow funds to pay either charitable program expenses or administrative expenses, independently from its decision, either before the borrowing or after the borrowing, to purchase investment assets. Our basic premise, which is supported by the language and construction of section 514, is that, absent some indication that an organization is attempting to circumvent section 514, any funds it borrows should be traced to the property acquired or expense paid with those funds. Guidance that applies this tracing principle more broadly than the Regulations already do would both simplify and clarify how section 514 applies in a great many situations.

Our first example, Example A, illustrates a typical situation in which an exempt organization borrows funds to acquire property for use in its charitable activities at a time when the borrowing makes business sense, and later, independently, decides to make an investment using available cash at a time when the investment is presented and makes business sense.

The next three examples – Examples B, C, and D – each illustrates a typical modern-day situation in which an exempt organization does not know, or have reason to know, that making an investment would cause it to make an independent decision later to borrow funds to support its charitable programs or to pay other operating expenses.

We respectfully suggest that the Service consider issuing some form of guidance that would recognize the principles set forth in these four new examples.
DISCUSSION

GENERAL UBIT PRINCIPLES

Section 501(a) provides that, with certain exceptions, an organization described in section 501(c) will be exempt from federal tax. One exception is the unrelated business income tax ("UBIT") set forth in sections 511-515. Section 511 imposes UBIT on an exempt organization’s unrelated business taxable income ("UBTI").

Section 512 defines UBTI as “the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).” Section 513 provides that an unrelated trade or business is “any trade or business the conduct of which is not substantially related … to the exercise or performance by such organization of its charitable, educational, or other purposes or function constituting the basis for its exemption…..” Section 513 provides exceptions from UBTI that are not directly relevant to these Comments.

Among the modifications to UBTI in section 512(b) are exclusions for certain types of passive income, including dividends, interest, royalties, rents from real property, and gains or losses from the sale or exchange of investment property. Section 512(b)(4) overrides these exclusions and subjects passive income to UBIT where the passive income is derived from “debt-financed property” as defined in section 514.

Definition of “Acquisition Indebtedness”

Section 514(b) defines “debt-financed property” as any property that is held to produce income and with respect to which there is an acquisition indebtedness either (1) at any time during the taxable year or (2) for property disposed of during the taxable year, at any time during the 12-month period ending with the disposition. Accordingly, for section 514 to apply, there must be: (1) property that is held to produce income; (2) indebtedness; and (3) a connection between the property and the indebtedness that causes the debt to be treated as “acquisition indebtedness.”

The definitions of “property held to produce income” and “indebtedness” are relatively straightforward. Although there are several exceptions for various types of property, investment property is generally treated as “property” for this purpose.

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5 Tax exemption under section 501(a) also extends to organizations described in sections 401(a) and 501(d).
6 UBIT also applies to organizations described in section 401(a) and to state colleges and universities.
7 See generally Reg. § 1.514(b)-1(a).
8 See generally Reg. § 1.514(c)-1.
9 I.R.C. § 514(b)(1).
10 See generally Reg. § 1.514(b)-1.
“Indebtedness” includes a standard loan, whether secured or unsecured, a line of credit, and borrowing from a margin account.\(^{11}\)

The difficulty and lack of clarity in applying section 514 in this context arises from the need to define the link between property and debt that is sufficient to make the debt “acquisition indebtedness.” Subject to several specific exceptions,\(^ {12}\) section 514(c) defines “acquisition indebtedness” to include debt incurred with respect to property in only three situations:

a. Debt incurred by the organization in acquiring or improving the property;

b. Debt incurred before the acquisition or improvement of the property if the debt would not have been incurred but for the acquisition or improvement; or

c. Debt incurred after the acquisition or improvement of the property if the debt would not have been incurred but for the acquisition or improvement and incurring the debt was reasonably foreseeable at the time of the acquisition or improvement.

The first situation is straightforward and involves debt that is incurred at the time property is acquired or improved for the purpose of acquiring or improving the property.\(^ {13}\) The more difficult issues arise in the second and third situations, in which debt incurred before or after property is acquired or improved must satisfy a “but for” test to be treated as acquisition indebtedness. In addition to the “but for” test, debt incurred after property is acquired or improved must meet a “reasonably foreseeable” test to be treated as acquisition indebtedness.

**Purpose of “But For” and “Reasonably Foreseeable” Tests**

The General Explanation of the Tax Reform Act of 1969\(^ {14}\) provides clear insights into the Congressional intent underlying the “but for” and “reasonably foreseeable” tests. The General Explanation establishes two principles. First, if an organization borrows money and immediately uses it for exempt purposes, it is generally assumed that the

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\(^{11}\) See Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States, 208 F.3d 147, 156 (2d Cir. 2000) ("Bartels I"), where the taxpayer tried to argue, without success, that margin debt was not subject to section 514; see also The Henry E. and Nancy Horton Bartels Trust For The Benefit Of Cornell University v. United States, 617 F.3d 1357 (Fed. Cir. 2010), reaching the same conclusion as Bartels I; see also Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347 (3rd Cir. 1980), reaching the same conclusion where an employee profit-sharing plan purchased securities on margin.

\(^{12}\) I.R.C. § 514(c)(2)-(9).

\(^{13}\) I.R.C. § 514(c)(1)(A).

\(^{14}\) Staff of the Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172 (JCS-16-70), 62-66 (December 3, 1970) (hereinafter, the “General Explanation”).
borrowing is for exempt purposes and is not subject to section 514. Second, the “but for” and “reasonably foreseeable” tests were intended as anti-abuse measures to identify situations in which an organization borrows money before or after the acquisition or improvement of property in an attempt to circumvent section 514. The General Explanation describes acquisition indebtedness as follows:

Income producing property is considered to be debt-financed property (making income from it taxable) only where there is an “acquisition indebtedness” attributable to it. Acquisition indebtedness exists with respect to property whenever the indebtedness was incurred in acquiring or improving the property, or the indebtedness would not have been incurred “but for” the acquisition or improvement of the property. Thus, for example, where a church has a portfolio of investments with no debt, and subsequently incurs a debt to construct a church related building, such as a seminary, such debt will not be considered acquisition indebtedness with respect to the investment portfolio.

If an indebtedness is incurred after the property is acquired or improved, it would not be “acquisition indebtedness” unless its incurrence was reasonably foreseeable at the time of the acquisition or improvement. If property is acquired subject to a mortgage, the mortgage is to be treated as an acquisition indebtedness incurred by the organization when the property is acquired.

Under the Act, as indicated above, unrelated debt-financed income will be subject to tax only if the income arises from property acquired or improved with borrowed funds and the production of the income is unrelated to the educational, charitable, religious, or other purpose constituting the basis of the organization’s tax exemption. For example, where a charitable organization pledges recently acquired property to borrow funds which it immediately uses for its tax exempt purposes and neither the donor of the pledged property nor any other private individual receive any direct or indirect financial benefit (either as a result of the transfer of the property or the borrowing by the organization) it will be assumed that the borrowing is for the organization’s exempt purposes. Of course, this could not be used to circumvent this provision where investment property is also acquired and the borrowing would not have occurred but for the investment property acquisition.\(^\text{15}\)

The General Explanation thus states an assumption that debt should be traced to the property acquired or expense paid with the debt proceeds. The “but for” and “reasonably foreseeable” tests are designed to identify abusive situations that contradict this assumption.

\(^{15}\) Id. at 63-64 (Emphasis added.)
Existing Authority and Private Letter Rulings

Examples in the existing Regulations and other authorities support this view of Congressional intent in the General Explanation. One of the examples in the existing Regulations applies the “but for” test to an organization that pledges investments to secure a loan and then uses the loan proceeds to purchase an office building that it leases to the public for non-exempt purposes. This example treats the loan as acquisition debt incurred prior to the acquisition of the office building because the debt would not have been incurred “but for” the acquisition. This example does not involve an attempt to circumvent section 514, but is entirely consistent with the General Explanation’s general tracing assumption.

Two other examples in the existing Regulations apply the “but for” and “reasonably foreseeable” tests to thwart attempts to circumvent section 514. In one example, an organization uses working capital that was necessary to continue current operations to remodel an office building held to produce rent. The office building is treated as debt-financed property when the organization later borrows funds to replace the working capital needed to continue its operations. This example prevents an exempt organization from circumventing section 514 by reducing its working capital below the amount necessary to continue current operations in order to acquire investment property when it knows that it will then have to incur debt to replenish that working capital.

In another example in the Regulations, an exempt school sells a classroom building to an unrelated organization and takes back a purchase money mortgage of $2 million. At the time of the sale, the school knows that it will need to replace the classroom building and borrow funds to do so. In the following year, the school borrows $2.5 million to finance construction of a new classroom building. Because the construction loan was reasonably foreseeable at the time the purchase money mortgage was acquired, and because it also meets the “but for” test, the example treats $2 million of the $2.5 million construction financing as acquisition indebtedness with respect to the $2 million purchase money mortgage. This example prevents an organization from selling exempt-use assets that it knows it must replace, and then using the sale proceeds to acquire investment assets where it is reasonably foreseeable that it must incur debt in order to replace the exempt-use assets. This is treated as circumventing section 514 in a manner similar to the use of working capital in the example above.

In a private letter ruling (“PLR”), a university’s section 501(c)(2) title holding corporation subsidiary borrowed money to make a payment with respect to rental

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16 Reg. § 1.514(c)-1(a)(2), Example (1).
17 See also, Kern County Electrical Pension Fund v. Commissioner, 96 T.C. 845 (1991) (organization pledged investment assets to secure a loan to acquire new investment assets and the loan was held to represent acquisition indebtedness under section 514(c)(1)(A)); GCM 37386 (Jan. 12, 1978).
18 Reg. § 1.514(c)-1(a)(2), Example (2).
19 Reg. § 1.514(c)-1(a)(2), Example (3).
20 PLR 7841005 (July 16, 1978).
property that it had held for more than five years. Despite finding that the organization
would not have incurred the debt but for the acquisition of the rental property, the Service
found that the debt was not reasonably foreseeable at the time the rental property was
acquired, and as a result there was no acquisition indebtedness. This PLR illustrates the
principle that to be treated as acquisition indebtedness, debt incurred after the acquisition
or improvement of property must satisfy the “reasonably foreseeable” test as well as the
“but for” test.

The Service has also held in PLRs that short-term borrowing to meet
administrative needs is not acquisition indebtedness. Some of these PLRs involve
indebtedness incurred by a pension fund to meet deadlines for payment of pension
benefits where the loan is repaid in a matter of days or weeks and is relatively de minimis. In these PLRs, the Service reasoned that the loan was not incurred for the
purpose of acquiring investment property, but rather for the purpose of solving a
temporary cash flow problem in a relatively de minimis amount. The debt was, in effect,
traced to its use to pay pension benefits. The organization was not attempting to
circumvent section 514.

Short-term borrowing was also involved in another PLR where an exempt
charitable organization owned shares in a common trust fund. The organization was
treated as directly conducting its proportionate share of the investment activity of the
common trust fund and borrowings of the fund were attributed to the exempt organization
in proportion to its ownership interest. The common trust fund maintained a five percent
cash reserve. When a participant redeemed its investment units, the redemption was
funded by the cash reserve, cash inflows, and proceeds of selling securities. In its ruling
request, the common trust fund proposed to cover any shortfall by borrowing on a line of
credit with an unrelated lender. These borrowings would be used solely for the purpose
of redeeming units of the fund and not for making additional investments. The line of
credit required the borrowing to be repaid within 30 days, but the common trust fund
estimated that it normally would repay the loans within 20 days or less, and that the need
to use the line of credit would arise infrequently. The Service ruled that the loans under
the line of credit would not constitute acquisition indebtedness because the debt proceeds
would not be used to acquire or improve investment property.

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21 PLR 8721107 (Feb. 27, 1987); PLR 9644063 (Nov. 1, 1996); PLR 200010061 (Dec. 17, 1999).
22 PLR 200320027 (Feb. 20, 2003).
NEED FOR FURTHER GUIDANCE AND EXAMPLES

Exempt organizations with investment portfolios sometimes need to borrow money to fund their charitable activities or to pay operating expenses such as payroll. They borrow in lieu of liquidating existing investments because liquidating investments may be disadvantageous or impossible due to economic conditions, illiquidity, contractual provisions, or other circumstances. These circumstances have arisen far more often recently due to the Great Recession and the resulting problems that both grantmaking and operating charities have faced in trying to maintain their level of charitable activity in the face of an extraordinarily difficult financial climate.

Existing authorities do not provide adequate guidance to allow exempt organizations to incur debt to fund exempt activities or to pay administrative expenses without being concerned that section 514 might apply to the debt. We have prepared four examples of such borrowings that we believe do not involve acquisition indebtedness. The Service’s adoption of these examples in guidance upon which taxpayers may rely would be extremely useful to the exempt organizations community. Example A involves a borrowing prior to acquiring investment property where the “but for” test is not satisfied. Examples B, C, and D involve borrowings for exempt or administrative purposes that are incurred after investments have been made where either the “but for” test or the “reasonably foreseeable” test is not satisfied.

The Joint Committee’s General Explanation indicates that there should be an assumption that borrowed money is traced to the asset acquired or expense paid with the money unless the organization is attempting to circumvent section 514. The existing authorities and PLRs are entirely consistent with such an assumption. Where an organization attempts to circumvent section 514, the “but for” and “reasonably foreseeable” tests of section 514(c)(1)(B) and (C) provide anti-abuse mechanisms to curb such manipulation.

We believe that in determining whether a borrowing represents acquisition indebtedness, an organization should be allowed, as a general rule, to trace the use of the proceeds of the debt to the asset acquired or expense paid with those proceeds.23 If the proceeds are used for an exempt purpose, the borrowing generally should not be treated as acquisition indebtedness with respect to any investment assets the organization may own or acquire contemporaneously. In those situations where the organization attempts to circumvent section 514 based on application of the “but for” and “reasonably foreseeable” tests, then tracing could be overridden. As explained above, in our view, the general application of tracing subject to using the “but for” and “reasonably foreseeable”

23 Tracing appears to work well in Temp. Reg. § 1.163-8T, T.D. 8145, 52 Fed. Reg. 24996 (July 2, 1987), to allocate interest expense in applying the passive loss rules of section 469 and the limitations on deductions for non-business interest under section 163(d) and (h). Under Temp. Reg. § 1.163-8T(a)(3), interest expense on a debt is generally allocated in the same manner as the debt itself is allocated, and the debt is allocated “by tracing disbursements of the debt proceeds to specific expenditures.” Temp. Reg. § 1.163-8T is of limited application here because it does not contain anti-abuse measures like the “but for” and “reasonably foreseeable” tests that apply in defining “acquisition indebtedness.”
tests as an anti-abuse mechanism is consistent with the existing examples in the Regulations.

In each of the four examples we recommend below, borrowed funds are traced directly to the asset acquired or expense paid, and, by applying the “but for” and “reasonably foreseeable” tests, one can see that there is no attempt to circumvent section 514.

**Example A:**

A section 501(c)(3) secondary school holds $Z in money market funds in addition to the amount of working capital necessary to continue current operations. The organization needs approximately $Z to construct a new classroom building. The current interest rates are quite low, and lenders, although reluctant to lend unsecured funds, are willing to provide construction loans that will ultimately be converted into long-term loans secured by the new classroom building. Rather than using the $Z in its money market funds, the organization decides to take out a construction loan, secured by a general pledge of its assets, to finance the construction of its new building. After taking out the loan and beginning the project, the organization is presented with an attractive investment opportunity that it did not foresee at the time of the borrowing, and it decides to use funds from the money market account to make that investment. Accordingly, any income from the new investment opportunity will not generate UBIT because the investment was not acquired with acquisition indebtedness.

**Analysis.** Applying the general tracing rule, the construction loan is attributable to the construction project, which is substantially related to the organization’s exempt purpose of operating a school, even though it is secured by a general pledge of the organization’s assets. The indebtedness is incurred before the acquisition of the new investment. Therefore, the new investment property would generate UBIT, only if the “indebtedness would not have been incurred but for such acquisition.” Under the facts stated, the organization made an independent decision to incur the construction debt for reasons unrelated to the new investments. Further, the cash used to make the new investments did not reduce the organization’s working capital below the amount necessary to continue current operations. Thus, there is no “but for” connection between incurring the debt and acquiring the investments. Therefore, the construction debt should not be acquisition indebtedness.

**Example B:**

A section 501(c)(3) grantmaking organization historically has made grants of $X each year and has funded those grants from interest, dividends, and capital gains from its investments. The organization decides to increase its grantmaking, in light of economic and environmental factors that are currently adversely affecting the charitable class that it serves. In a particular year, interest, dividends and capital gains are insufficient to enable the organization to increase its grantmaking and to pay its administrative expenses, including payroll. The Board of Directors reasonably determines that it would not be
advantageous to liquidate the organization’s various investments at this time. On that basis, the Board decides to fund the organization’s grantmaking program (including expenses) with funds borrowed under a line of credit. The line of credit is secured by the organization’s existing investments. The organization did not anticipate at the time it made its investments that it would later decide to increase its grantmaking at a time when its income was insufficient to fund its programs and when it was also reasonable to hold its investments rather than to liquidate them. Accordingly, any income from the existing investments will not generate UBIT solely because of the funds borrowed under the line of credit.

Analysis. Here the debt is incurred after the organization made the investments. The organization incurs debt specifically to make grants and pay its expenses, and the proceeds of the debt can be traced to those uses. The various conditions giving rise to the organization’s decision to borrow to fund these uses without liquidating its investments were not reasonably foreseeable at the time the investments were made. In addition, there is no “but for” connection between incurring the debt and acquiring the assets, since the debt is incurred to increase the organization’s grantmaking. The Joint Committee’s General Explanation suggests that Congress intended exempt organizations to be able to borrow to acquire charitable assets or to pay charitable expenses without incurring acquisition indebtedness, absent an attempt to circumvent section 514. No such attempt is presented by these facts, so income from the existing investments should not generate UBIT.

Example C:

A section 501(c)(3) grantmaking organization, as part of its investment program, holds among its investment assets interests in five limited liability companies (“LLCs”) that invest in venture capital transactions. The terms of the LLCs’ operating agreements require that the organization contribute $Y capital to the LLCs in equal amounts over five years at the option of the LLCs. The organization has on hand $Y to fund those required contributions. When the organization invested in the LLCs and incurred the capital commitment, the Board reasonably expected that the organization would have interest, dividends, and capital gains from other investments to fund its grantmaking program and to pay its administrative expenses, including payroll. In a particular year, the organization does not receive sufficient income to carry out its grantmaking program and to pay its expenses. The Board reasonably decides to borrow to fund its grantmaking program and to pay expenses and to continue to hold $Y to fund its capital commitments to the five LLCs when due. Accordingly, the decline in income and the consequent need to borrow to fund the organization’s grantmaking program and expenses were not reasonably foreseeable at the time the capital commitments were made. Further, there is no “but for” connection between the prior investments and capital commitments and the later borrowing. Therefore, any income from the existing investments will not generate UBIT solely because of the funds borrowed to fund the organization’s grantmaking program and expenses.
**Analysis.** Here the debt is incurred after the organization has made the specific investments described and incurred the capital commitments. The organization incurs debt specifically in order to conduct its charitable activities and to pay its expenses, and not to acquire or improve any investment property. The various conditions giving rise to the organization’s decision to borrow to fund its programs were not reasonably foreseeable at the time its investments and capital commitments were made or incurred. In addition, there is no “but for” connection between incurring the debt and acquiring interests in the LLCs or other investments. Consistent with the Joint Committee’s General Explanation, the exempt organization should be allowed to trace the debt proceeds to an exempt use because there is no attempt to circumvent section 514.

**Example D:**

A section 501(c)(3) organization holds an investment portfolio that includes equity and debt investments, money market funds and cash. The organization buys and sells investments on a continuous basis under the direction of its investment advisors. Excess cash, including working capital, is invested in short term securities daily. The excess cash is managed internally by investment professionals employed by the organization.

The organization has a line of credit that it occasionally uses for short term cash flow needs in connection with its charitable programs, where working capital is insufficient. The organization typically repays its line of credit draws within 20 days. It does not use the line of credit to make investments. Because there is no “but for” connection between the organization’s investments and its occasional line of credit draws, there is no debt financed income under Section 514.

**Analysis.** The debt is incurred at the same time that the organization is buying and selling investments in a continuous investment program conducted by its investment advisors. The organization incurs debt specifically for the purpose of funding charitable expenditures, and any debt that is incurred may be incurred either just before or just after investments are made, and on certain occasions on the same day. However, the organization is able to trace the disbursement of debt proceeds to specific charitable expenditures. In PLRs 200010061 (December 17, 1999) and 200233037 (May 13, 2002), relying on Rev. Rul. 78-88, 1978-1 C.B. 163, the Service held that a tax-exempt pension plan could draw on a line of credit, on a short term basis, to cover its operating expenses. These were “short-term borrowings for the purpose of facilitating … [the organization’s exempt purpose].” In addition, the Service noted that “the temporary payment obligations are not debts incurred for the purpose of making and carrying additional investments to which the debt-financed rules apply.”