

## LTR 8604089

### Section 514 -- Unrelated Debt-Financed Income

#### Summary

#### LIMITED PARTNERSHIP'S INVESTMENTS IN WRAP-AROUND MORTGAGES WILL NOT CONSTITUTE DEBT-FINANCED PROPERTY.

A limited partnership will serve as an investment vehicle for qualified profit sharing, pension, and other retirement trusts, as well as for Keogh plans, individual retirement accounts, and government pension and retirement trusts. The partnership will make junior mortgage loans, first mortgage loans, and wrap-around mortgage loans. A wrap-around note will normally provide for payments at least equal to the amounts due under the first mortgage, but not always.

The Service has ruled that the partnership's income from wrap-around mortgage loans will be characterized as interest income to the limited partners and will not constitute gross income from an unrelated trade or business. The Service held that the wrap-around mortgage notes do not constitute debt-financed property under section 514(b).

#### Full Text

October 31, 1985

Legend:

Partnership M = \* \* \*

Gentlemen: \* \* \*

In a letter dated September 6, 1984, your authorized representative requested a ruling that income from certain assets Partnership M intends to purchase will not constitute gross income derived from an unrelated trade or business to the partners of Partnership M for purposes of section 512 of the Internal Revenue Code.

Partnership M is a limited partnership which intends to make junior mortgage loans, and to a lesser extent may make other mortgage loans, including first mortgage loans and wrap-around mortgage loans, and to make other loans secured indirectly by interests in real property, and as such, intends to serve as an investment vehicle for qualified profit-sharing, pension and other retirement trusts; bank commingled trust funds for such trusts; HR - 10 (Keogh) Plans and Individual Retirement Accounts; government pension and retirement trusts; and other entities intended to be exempt from Federal income tax. The Partnership objectives are (i) to preserve and protect limited partners' capital, (ii) to provide the limited partners with regular quarterly cash distributions, (iii) to maximize cash distributions over the life of the partnership by making high yielding loans, secured

directly or indirectly by interests in real property, and (iv) to provide a hedge against inflation through equity participations in loans providing for additional interest payments to the Partnership.

Although the amortization schedule on a wrap-around note will normally provide, at a minimum, for periodic payments equal to or in excess of amounts due under the first mortgage, that is not always the case. The parties are free to agree upon any amortization schedule they wish to accommodate their particular objectives. The effect of different amortization schedules is to alter the effective interest rate received by the wrap-around lender on the funds advanced.

Based on the foregoing, your authorized representative has requested the following rulings:

(1) Income received by Partnership M in connection with wrap-around mortgage loans will not constitute gross income derived from an unrelated trade or business for purposes of section 512 of the Code.

(2) Acquisition by an exempt organization of a security interest in debt-financed property owned by the borrower does not itself constitute acquisition of debt-financed property within the meaning of section 514(c)(2)(A) of the Code since the exempt organization does not have full use of the property and its income; nor does the wrap-around mortgage note itself constitute debt-financed property since there is no acquisition indebtedness of Partnership M with respect to such property.

Section 512(c) of the Code states that if an exempt organization is a member of a partnership regularly carrying on a trade or business which is an unrelated trade or business with respect to the exempt organization, the exempt organization's share of the gross income of the partnership from the unrelated trade or business, less its share of partnership deductions directly connected with such gross income, shall, subject to the modification stated in section 512(b), constitute unrelated business taxable income.

Section 511(b)(1) of the Code imposes a tax on the unrelated business taxable income of trusts that are exempt from taxation under section 501(a), including a trust that forms part of an employees' plan satisfying the requirements of Code section 401(a).

Section 512(a)(1) of the Code states, as a general rule, that the term "unrelated business taxable income" is defined as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less certain deductions.

Section 512(b)(1) of the Code excludes interest income from unrelated business taxable income. However, pursuant to section 512(b)(4), interest income from "debt-financed property" is treated as unrelated business taxable income.

Section 514(b) of the Code defines "debt-financed property" generally to include any property which is held to produce income and with respect to which there is an

"acquisition indebtedness" at any time during the taxable year. Section 514(c) defines "acquisition indebtedness" to include indebtedness incurred in acquiring or improving any debt-financed property. Section 514(c)(2)(A) provides, in part, that where property (no matter how acquired) is acquired subject to a mortgage or similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization does not assume or agree to pay such indebtedness.

Section 1.514(c) - 1(a)(2) of the Income Tax Regulations describes an exempt organization that invests borrowed funds as part of its investment in a partnership in which it holds a one-third interest. The partnership further borrows money to purchase a building which is leased to the general public for purposes not exempted from section 514 by section 514(b)(1)(A), (B), (C), or (D). The organization has acquisition indebtedness equal to the sum of the borrowed money invested in the partnership plus one-third of indebtedness incurred by the partnership to acquire the building.

Rev. Rul. 74-197, 1974 - 1 C.B. 143, concludes that a qualified trust may have unrelated business taxable income from its investment in a partnership that borrows funds to invest in securities to the extent that the trust's share of partnership income is derived from or on account of the debt-financed securities.

Based on Rev. Rul. 74-197, and section 1.514(c) - 1(a)(2) of the regulations, if the partnership borrows money to make its investments, the qualified trusts that are limited partners will have unrelated business taxable income.

Rev. Rul. 75-99, 1975 - 1 C.B. 197, concludes that the portion of payments received by a real estate trust from a borrower on a "wrap-around" mortgage loan and paid by the trust on the senior obligation are considered made on behalf of the borrower while the portion attributable to interest on the amount of cash advanced by the trust constitutes interest for purposes of section 856(c)(2) and (3) of the Code.

Where partnership M contracts with the borrower to use payments on the wrap-around note to service the prior mortgage, and Partnership M does not borrow funds in order to advance funds to the borrower, Partnership M will not be treated as borrowing money in order to acquire the borrower's note merely because the wrap-around note exceeds the amount advanced by the partnership.

Under the facts as presented, Partnership M would acquire one or more notes secured by an interest in property subordinate to one or more mortgages. We conclude that the property acquired by Partnership M is not subject to any "acquisition indebtedness", instead, the property acquired (the note) is an obligation to pay secured by the borrower's encumbered property. Thus, the note received by Partnership M would not constitute debt-financed property.

Accordingly, we conclude, with respect to your first ruling request, that income received by Partnership M in connection with wrap-around mortgage loans will be characterized,

as to exempt organizations participating in Partnership M as limited partners, as interest income and, thus, not constitute gross income derived from an unrelated trade or business for purposes of section 512 of the Code.

With respect to your second ruling request, we conclude that the wrap-around mortgage notes described in this ruling do not constitute debt-financed property within the meaning of section 514(b) of the Code.

A copy of this letter has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,  
John J. Swieca  
Chief, Employee Plans Rulings and Qualifications Branch