From: Laufer Janet A
Sent: Wednesday, August 08, 2007 3:24 PM
To: Fish David L
Cc: Binder Elizabeth R; Brokaw James L; Katz Sarah R; Fontenrose Robert
Subject: RE: 990-T tax rates for 501(c)(9) orgs.

Per our phone discussion on Friday 8/3, I am confirming our recommendation that a 990-T filer that is exempt under IRC sections 501(c)(7), (9), (17), or (20), be permitted to use Schedule D to compute UBIT. The effect is that the section 1(h)(11) capital gains rates would apply to qualified dividend income of a VEBA that is subject to UBIT under section 512.

Note that VEBAs are referred to in section 501(c)(9), and our understanding is that the issue of whether the filer is permitted to use Schedule D has thus far been raised only in the context of VEBAs, but we would reach the same conclusions with respect to 501(c)(7), (17) and (c)(20) organizations. We refer to VEBAs below for brevity.

Section 1(h)(11) was added to the Internal Revenue Code by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) and generally provides that qualified dividends paid to shareholders by a domestic corporation or qualified foreign corporation between 5/6/2003 and 12/31/2010 are taxed at capital gains rates.

Our analysis is as follows:

- Section 511(b)(1) imposes a tax on UBIT of every trust described in 511 (b)(2) that is "computed as provided in section 1(e)."
- Section 511(b)(2) says the (b)(1) tax applies to trusts that are exempt from tax (except as provided in part I or part III relating to private foundations) by reason of 501(a) and which if not for such exemption would be subject to subchapter J.
- Section 1(e) imposes a tax on the taxable income of every estate and every trust, and also sets forth tax rates. Section 1(h)(1) refers to "the tax imposed by this section", which could be read as not including tax imposed by section 511(b)(1) that is *computed* as provided in section 1 (e). However, we believe the better reading is that section 1(h) is written very broadly and is intended to apply to trusts otherwise subject to section 1(e) rates. Note also that we understand section 1(i), which modifies the section 1(e) rates, has been applied to exempt trusts.
- Because tax is imposed on exempt organizations under 511(b), we do not see a basis for distinguishing in applicability of 1(h) rates

between VEBAs and other types of exempt organizations. Although we are only aware of this issue having been raised with respect to VEBAs, there would be implications for exempt organizations other than VEBAs (including qualified plans) that have UBIT based on debt-financed income under section 514.

- The issue would affect only exempt organizations structured as trusts, not corporations. VEBAs and qualified plans are structured as trusts; other exempt organizations are usually structured as corporations.
- We have considered that VEBA UBIT is imposed under section 512(a)(3), which is a function of the section 419A account limit being exceeded as well as the VEBA having income. Under regulation See section 1.512(a)-5T, Q&A 3(b): UBIT of a VEBA is the lesser of the income or the excess of the total amount at the end of the year over the section 419A account limit. For this purpose, reserves for postretirement medical is not included in the account limit and (See section 512(a)(3)(E)) and so postretirement medical reserves are subject to UBIT to to the extent thee is income.
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