

Unrelated income; interest and service fees on mortgage loans. Interest income earned by an exempt employees trust from mortgage loans, which form a significant portion of the trusts' assets, does not enter into the computation of unrelated business taxable income under section 512 of the Code. Service fee receipts earned by the trust in connection with such loans, however, do enter into the computation.

Advice has been requested whether an exempt employees' trust has 'unrelated business taxable income' within the meaning of section 512 of the Internal Revenue Code under the circumstances described below.

An exempt employees' trust described in section 401(a) of the Code continually holds a substantial number of mortgage loans. These loans form a significant portion of the total assets of the trust. The trust has consistently derived interest income and service fees from such loans in amounts constituting a significant percentage of the income of the trust during the past four years.

Each year the trust receives several hundred loan applications from corporations, firms, partnerships, and individuals from all over the United States. While the trust does not otherwise advertise this activity, it does erect billboards on construction sites which show that it has financed the project. Further, the trust is well known as a lender in the mortgage industry.

Loan applications are screened by a steering committee consisting of attorneys, accountants, appraisers and other personnel employed by the trust. The lending activities are conducted on a year-round basis and the loans made are competitive with those made by commercial institutions.

The service fee receipts represent earnest money deposits and prepaid service fees equal to one percent of the principal amount of each loan for legal, closing, appraisal, and accounting costs related to the loan. There is no acquisition indebtedness (as defined in section 514(c) of the Code) with respect to the trust's assets.

Section 511 of the Code imposes a tax on the unrelated business taxable income of certain exempt organizations, including exempt employees' trusts described in section 401(a).

Section 512(a) of the Code states that, except as otherwise provided therein, the term 'unrelated business taxable income' means the gross income derived by an organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the allowed deductions which are directly

connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b) of the Code excludes interest income from the computation of unrelated business taxable income.

Section 513(b) of the Code states that the term 'unrelated trade or business' means, in the case of a trust described in section 401(a), any trade or business regularly carried on by such trust. For the purpose of section 513 the term 'trade or business' generally includes any activity carried on for the production of income from the sale of goods or performance of services. See section 1.513-1(b) of the regulations.

Section 1.513-1(c)(1) of the regulations states that, in determining whether trade or business from which a particular amount of gross income derives is 'regularly carried on,' within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be 'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

In this case, the volume of loan activity and manner in which the trust organizes and maintains its mortgage loan operations are comparable to these same activities by banks, savings and loan associations, insurance companies, and similar commercial institutions which compete for mortgage loan business for a profit.

Based on the standards set out in the foregoing regulations, this mortgage loan activity constitutes trade or business regularly carried on by the trust within the meaning of section 513 of the Code.

Subject to certain exceptions not present in this case, however, section 512(b)(1) of the Code and section 1.512(b)-1(a) of the regulations exclude interest income from the computation of unrelated business taxable income. Interest paid on loans made by the exempt employees', trust is interest within the meaning of section 512(b)(1) and therefore is excluded from the computation of unrelated business taxable income.

The service fees receipts described above, however, are not interest. Rev. Rul. 69-188, 1969-1 C.B. 54, sets forth certain criteria for use in determining whether a debtor-creditor relationship exists for the purposes of treating as interest a

'loan processing fee' (points) paid by a mortgagor-borrower as compensation to a lender solely for the use or forbearance of money. The Revenue Ruling holds that where the taxpayer is able to establish that the fee is paid as compensation to the lender solely for the use or forbearance of money, the fee is considered to be interest. It is not necessary that the parties to a transaction label a payment made for the use of money as interest for it to be treated as interest. Rev. Rul. 69-188 provides that, in order for such fees to be treated as interest, however, the fees must not be paid for any specific services that have been performed or will be performed in connection with the loan.

For example, interest would not include separate charges made for investigating the prospective borrower and his security, closing costs of the loan and papers drawn in connection therewith, or fees paid to a third party for servicing and collecting that particular loan. Also, even where service charges are not stated separately on the borrower's account, interest would not include amounts attributable to such services.

See Rev. Rul. 67-297, 1967-2 C.B. 87.

The service fees are attributable to specific services (i.e., legal, closing, appraisal, and accounting costs) performed in connection with each loan and are not paid as compensation to the trust solely for the use or forbearance of money. Therefore, such fees do not constitute interest and are not excluded from the computation of unrelated business taxable income under section 512(b)(1) of the Code.

Accordingly, the interest earned by the trust in this case from its mortgage loan business does not enter into the computation of unrelated business taxable income, but the service fee receipts earned by the trust in this case do enter into the computation of unrelated business taxable income.