DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Date: JUL 20 2000

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Dear Sir/Madam:

This letter is in response to your request for rulings under sections 501(c)(3), 513 and 514(c)(1) of the Internal Revenue Code.

FACTS

You are a nonprofit corporation created under the laws of a and have been recognized as an organization described in section 501(c)(3) of the Code. Your purposes are:

a. To preserve or aid in the preservation of all types of wild nature;

b. To establish nature reserves or other protected areas to be used for scientific, educational, and esthetic purposes;

c. To promote the conservation and proper use of our natural resources;

d. To engage in or promote the study of plant and animal communities and of other phases of ecology, natural history and conservation; and

e. To promote education in the fields of nature preservation and conservation.

Currently, individuals who own forestland will sell trees, usually through logging industry middlemen, to raise funds to meet pressing cash flow needs. This random harvesting of forests, however, jeopardizes the long-term conservation of forests in a manner that threatens the environment. To address this concern, you have developed a plan known as the "L" for the long-term conservation of individually owned forestland by eliminating the random cutting of forests that would otherwise occur as individuals

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allow trees on their property to be harvested to produce a source of revenue. The concept of the L is to amass a sufficiently large pool of "tree rights" (as explained below) and capital so that the forest can be managed in a more environmentally compatible manner to assure the maintenance of ecological services and the health of the ecosystem.

In furtherance of this conservation objective, you intend to create a limited liability company, the "M" (hereafter, "LLC"). The purpose of LLC will be to acquire from individual owners of forestland the rights to maintain, conserve, selectively cut and manage, sell (and retain the proceeds therefrom) and replant the trees located on each owner's property. (These rights are collectively referred to as "Tree Rights" and the individuals owning forestland who participate in this program are referred to as "Participants.")

The members of LLC would consist of you and the Participants. The governing document will be the Limited Liability Company Agreement (the "LLC Agreement") between you and the Participants. The LLC Agreement will provide that you will be the manager of LLC. Under the LLC Agreement, LLC will not elect to be classified as a corporation.

The LLC Agreement will expressly provide that its purposes are: (a) to conserve forestland to maintain ecological features and natural processes, and (b) to manage such lands, forest and associated resources to provide economic and financial benefits. The LLC Agreement will also expressly state that in the event of a conflict between these two purposes, (a) will control. In addition, the LLC Agreement will expressly state that LLC must be operated to advance these purposes without regard to whether such purposes, or the activities of LLC to achieve these purposes, earn a profit for LLC or its members.

You will make a cash contribution to LLC in exchange for your membership interest. The amount of your capital contribution will be that amount which you determine, based upon financial projections, to be sufficient to fund the commencement of activities by LLC. Your initial capital contribution will not exceed b. You are under no binding obligation to make any additional capital contributions to LLC. However, because you are committed to the success of LLC's long-term conservation goals, you at all times have the discretion to make additional capital contributions.

LLC will obtain Tree Rights from each Participant by means of an easement. The Participants will retain title to the land on which the trees are located. Under this easement (the "Forest Conservation and Management Easement"), the Participant will be prohibited from allowing any commercial or other development of the property or otherwise using the property in a manner inconsistent with the preservation and protection of the forest conservation values of the property. In addition, LLC will have the authority to perform forest management activities, harvest forest products and replant.

In certain circumstances, prior to a grant of Tree Rights to LLC, a Participant may grant a separate conservation easement directly to you. Under this easement (the "Forest Conservation Easement"), the Participant refrains from allowing any commercial or other development of the property or certain other activities inconsistent with forest conservation. In this case, the Participant will contribute a modified Tree Rights easement ("Forest Management Easement") to LLC.

Only Tree Rights that have been owned by an individual for at least one year will be eligible for transfer to LLC. Each Participant who transfers Tree Rights to LLC will be issued a membership interest in LLC ("Membership Interest"). The face amount of the Membership Interest will equal the fair market value of the Tree Rights on the date they are transferred to LLC. Each Membership Interest will provide for an annual minimum return to the Participant, between x and y percent of the fair market value of the

Tree Rights. In any year in which LLC's operations produce excess cash flow, LLC's management, at its discretion, may declare additional distributions to Participants.

In the event the minimum annual return due on the outstanding membership interests is not paid for any two consecutive years, the owners of at least two-thirds of the outstanding interests in LLC could vote to replace you as manager of LLC. However, any manager selected to replace you would have to (a) agree to assume all of your obligations under all of the agreements pertaining to LLC, (b) be a tax-exempt organization described in section 501(c)(3) of the Code, the primary purpose of which is the conservation of forestland, and (c) acknowledge and agree that the furtherance of such conservation purpose takes precedence over any fiduciary duty the manager would otherwise have to earn a profit for the Participants.

The Membership Interests will be freely transferable by Participants. A Participant may withdraw the invested amount in his or her membership interest, in whole or in part, at any time following the first anniversary of his or her contribution of Tree Rights to LLC.

You have represented that for federal income tax purposes, the Membership Interest of each Participant constitutes an equity interest in LLC, and not a debt instrument issued by LLC.

LLC will make all decisions regarding maintenance, conservation, logging and selling of forest, and replanting on such properties. (LLC Agreement, Secs. 1.8, 6.1.)

LLC will need to generate sufficient cash flow to fund its operations and to make the minimum annual return payments to the Participants. LLC's only source of income will be from forest harvesting activities, but LLC will not engage in such activities solely to meet cash flow needs without regard to long-term conservation objectives. If LLC does not have sufficient cash for these purposes, you may, but are not required to, contribute additional capital to LLC. (LLC Agreement, Sec. 2.4)

Consistent with LLC's purposes, there are a wide array of circumstances that would lead to a decision by LLC to cut timber pursuant to the grant of Tree Rights from Participants. Harvesting of forestland by LLC will only be done to the extent it is compatible with and in furtherance of your long-term conservation objectives. One primary purpose of LLC is to eliminate the random cutting of individual-owned forestland because of its severe adverse effect on long-term forest preservation. However, the particular facts and circumstances leading to a decision to cut timber may be directed solely at conservation or may include other factors, including revenue considerations. Thus, each decision to harvest forestland which is not undertaken solely for conservation purposes is likely to be based upon a combination of conservation objectives and other factors, including revenue production.

LLC will have no employees. You will employ the two individuals who will carry out the business affairs of LLC, the L Director and the Operations Manager of the N. In addition, you will also hire an administrative assistant. In the future, it may become necessary to devote additional employees to LLC.

Your operating budget for fiscal 1999 and fiscal 2000 is c and d, respectively. For fiscal 1999 and fiscal 2000, you budgeted e and f full time employee equivalents, respectively.

RULINGS REQUESTED

1. Your participation as manager of LLC pursuant to the terms of the LLC Agreement, and your obligations and activities with respect to LLC, will not impair your status as a tax-exempt organization described in section 501(c)(3) of the Code.

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2. LLC's activities do not constitute the conduct of an unrelated trade or business for purposes of section 513 of the Code.

3. With respect to LLC's acquisition of Tree Rights, the Membership Interests do not constitute acquisition indebtedness, as defined in section 514(c)(1) of the Code.

APPLICABLE LAW

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in section 501(c)(3).

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, scientific or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that for an organization to be exempt as one described in section 501(c)(3) of the Code, it must be both organized and operated exclusively for one or more exempt purposes. Under section 1.501(c)(3)-1(d)(1)(i)(b), an exempt purpose includes a charitable purpose.

Section 1.501(c)(3)-1(b)(1) of the regulations provides that an organization is organized exclusively for one or more exempt purposes only if its articles of organization (a) limit the purposes of such organization to one or more exempt purposes and (b) do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization is operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(e)(1) of the regulations states that an organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) of the Code.

Section 301.7701-3(b)(1) of the regulations provides that if an eligible entity (such as a limited liability company), which has two or more members, does not elect to be treated as a corporation, it will be treated as a partnership.

In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Court stated that "the presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

In Butler v. Commissioner, 36 T.C. 1097 (1961), acq. 1962-2 C.B. 4, the Tax Court noted that "[b]y reason of being a partner in a business, petitioner was individually engaged in business." 36 T.C. at 1106.

Rev. Rul. 76-204, 1976-1 C.B. 152, holds that an organization formed for the purpose of preserving the natural environment by acquiring and maintaining ecologically significant undeveloped land

is operated exclusively for charitable purposes and qualifies for recognition of exemption as an organization described in section 501(c)(3) of the Code. This revenue ruling states that by acquiring and preserving such land (whether by self-maintenance or through transfer to a government agency), the organization is enhancing the accomplishment of the express national policy of conserving the nation's unique natural resources.

Section 511 of the Code, in part, generally imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business, both computed with certain modifications.

Section 512(b)(5) of the Code generally excludes from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property. However, this provision does not apply with respect to the cutting of timber that is considered, on the application of section 631, as a sale or exchange of such timber. Section 1.512(b)-1(d)(1) of the regulations specifies that this exclusion does not apply with respect to the cutting of timber, which is considered, upon the application of section 631(a), as a sale or exchange of such timber.

Section 631(a) of the Code provides that a taxpayer may make an election affecting the federal income tax treatment of certain timber cut during the taxable year. Section 631(b) provides that the disposal of certain timber is treated as a gain or loss from the sale of such timber.

Section 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to the organization, such organization, when computing its unrelated trade or business taxable income, must include its share of the partnership's gross income from such unrelated trade or business, and its share of the partnership deductions directly connected with such gross income.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption.

Section 1.513-1(a) of the regulations defines the term "unrelated business taxable income" as gross income derived by an organization from any unrelated trade or business regularly carried on by it, less directly connected deductions and subject to certain modifications. Therefore, gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(1) of the regulations states that the presence of the substantially related requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

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Section 1.513-1(d)(2) of the regulations states that a trade or business is related to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of an exempt purpose, and is substantially related for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 514 of the Code provides that in computing unrelated business taxable income under section 512, an organization must include with respect to each debt-financed property a certain portion of the gross income derived from an unrelated trade or business. The portion included is the same percentage as the average acquisition indebtedness for the taxable years with respect to the property is of the average amount of the adjusted basis of the property during the period held by the organization during the taxable year.

Section 514(b)(1) of the Code defines the term "debt-financed property" as any property held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year.

Section 514(c)(1) of the Code defines the term "acquisition indebtedness" as including, with respect to any debt-financed property, the unpaid amount of indebtedness incurred by the organization in acquiring or improving such property.

RATIONALE

Since LLC will not elect to be taxed as a corporation, under section 301.7701-3(b)(1) of the regulations, LLC will be treated as a partnership for federal income tax purposes. In addition, for federal income tax purposes, the activities of a partnership are often considered to be the activities of the partners. See, e.g., Butler, supra. Therefore, LLC's activities are attributed to your organization.

Following the creation of LLC, and taking into account the attribution of LLC's activities to your organization, you will continue to be organized exclusively for charitable purposes. Therefore, you will continue to satisfy the organizational test under section 1.501(c)(3)-1(b)(1) of the regulations. Following the creation of LLC, your activities will continue to focus on the conservation of natural resources, which, as noted in Rev. Rul. 76-204, supra, furthers an exempt purpose under section 501(3) of the Code. Based on the information provided, your participation in the activities of LLC as its manager will be consistent with your exempt purpose. Therefore, under the circumstances described, you will continue to satisfy the operational test under section 1.501(c)(3)-1(c)(1). Thus, following the creation of LLC, you will continue to satisfy the organizational and operational tests of section 1.501(c)(3)-1(a)(1). Accordingly, your participation as manager of LLC pursuant to the terms of the LLC Agreement, and your obligations and activities with respect to LLC will not adversely affect your status as an organization described in section 501(c)(3).

You have indicated that each time LLC decides to cut and sell timber, that decision may be based solely on long-term conservation objectives, or on a combination of long-term conservation objectives and other factors, including revenue production. If a decision by LLC to cut and sell timber were based solely on long-term conservation objectives, such activity would contribute importantly to the accomplishment of your exempt purpose under section 501(c)(3) of the Code. See section 1.513-1(d)(2) of the regulations. Such activity, therefore, would not constitute an unrelated trade or business under section 513. In contrast, if a decision by LLC to cut and sell timber were based solely on revenue objectives, or if

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conservation objectives were merely incidental to revenue or other objectives, such activity would not contribute importantly to the accomplishment of your exempt purpose under section 501(c)(3). See section 1.513-1(d)(2). Assuming that such activities were regularly carried on, they would constitute an unrelated trade or business under section 513.

With respect to sales of timber that constitute an unrelated trade or business, the modification for gain from the sale of property under section 512(b)(5) of the Code must be considered. Generally, gain from the sale of property is excluded from the computation of unrelated business taxable income under section 512(b)(5). However, this provision does not apply with respect to the cutting of timber, which is considered upon the application of section 631(a), as the sale or exchange of timber. While gains from section 631(a) dispositions are expressly removed from the section 512(b)(5) modification, transactions coming within section 631(b) may result in gains therefrom being excluded under section 512(b)(5).

Under section 514(b)(1) of the Code, debt-financed property includes any property held to produce income, with respect to which there is an acquisition indebtedness. Acquisition indebtedness is defined as the unpaid amount of indebtedness incurred by an organization in acquiring or improving debt-financed property. You have represented that for federal income tax purposes, the Membership Interest of each Participant constitutes an equity interest in LLC, and not a debt instrument issued by LLC. We express no opinion as to this representation. However, based on the information provided, including your representation, we believe you did not incur indebtedness in acquiring the Tree Rights, and the Participants' Membership Interests do not represent the unpaid amount of indebtedness incurred. Under these circumstances, the Membership Interests do not constitute acquisition indebtedness, as defined in section 514(c)(1).

RULINGS

1. Your participation as manager of LLC pursuant to the terms of the LLC Agreement, and your obligations and activities with respect to LLC, will not impair your status as a tax-exempt organization described in section 501(c)(3) of the Code.

2. A. Cutting and selling timber based solely on long-term conservation objectives does not constitute unrelated trade or business under section 513 of the Code.

   B. Cutting and selling timber based solely on revenue objectives, or where conservation objectives are merely incidental to revenue or other objectives, constitutes unrelated trade or business under section 513 of the Code, assuming that such activities are regularly carried on.

   C. If sales of timber constitute unrelated trade or business under section 513 of he Code, gains from section 631(a) dispositions are not excluded under section 512(b)(5). Transactions coming within section 631(b) may result in gains therefrom being excluded under section 512(b)(5).

3. As described above, Membership Interests do not constitute acquisition indebtedness, as defined in section 514(c)(1) of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based.

These rulings do not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

These rulings are directed only to the organization that requested them and may not be used or cited by others as precedent.

We are informing your Area Manager of this action. Please keep a copy of this letter in your permanent records.

If you have any questions about these rulings, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1