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

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Dear Sir or Madam:

This is in reply to A's request and subsequent correspondence for rulings on whether certain transactions by A would result in unrelated business taxable income under section 512 of the Internal Revenue Code.

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FACTS

A is a not-for-profit corporation exempt from federal income taxation under section 501(c)(3) of the Code by reason of its affiliation with J, which has group exemption.

As an integral part of J, A is responsible for some of J's operations within A's geographic area, which is the state of D. One of A's primary purposes is to foster the spread of the organization's purposes in J's tradition through outreach work. Although outreach work is often thought of as being conducted solely in foreign countries, J believes that its work includes finding new E members and establishing similar E organizations in the United States particularly in D. A, and J in general, fosters outreach work in a number of ways, including A's land purchase program.

Under the land purchase program, A uses demographic studies and projections to identify where future growth and development will take place. Recognizing that when a community grows, new E organizations will be needed to deal with the added population. In order to place new E organizations to deal with the added population, A tries to identify tracts of property (i.e. advance sites) to purchase. By purchasing the property ahead of the development activity, and in advance of any subsequent rise in real estate value that typically accompanies such development, A is often able to obtain land that can be used to establish an E organization or an E organization related school at a reduced price. When the development occurs and an E organization or E school is ready to be established, A transfers the advance site to the new E organization at cost, and often assists the new E organization in arranging financing through a related E organization, F. It is typically a great advantage for a new E organization to be able to purchase real estate for itself at a cost which is below the market rate. In many instances according to A, the reduced cost makes building possible at a time when the E organization most often has minimal funds available.

A prefers to purchase advance sites which are close to the exact amount of acreage necessary to establish an E organization or E school. However, as urban sprawl extends itself and subdivisions continue to branch out further from metropolitan areas, it is becoming more and more difficult to find advance sites in the desired dimensions. As such, A has, in a limited number of instances, purchased properties which were in excess of the amounts that were needed to build the intended structures. A represents that during the fifteen year tenure of a leading A official, a number of the advance sites acquired had excess acreage.

In g, A entered into negotiations with a family in C, D over farm land in the southern portion of C. This area was ripe for future development so the C property seemed well suited for an advance site. Negotiations began and it became apparent that he family was not interested in selling less than the entire parcel of C property. A did not need the entire tract of C property for its uses so the family and A began discussions with a potential developer.

The family's need to sell its whole parcel of C property with A's need to use only part of it was reconciled. The parties agreed upon an equity participation loan. Consequently, A purchased the C property from the family with funds provided by F. A then agreed to finance the sale of the portion of C property that was in excess of A's needs to a developer through a subordinated promissory note and need of trust. The developer must repay A the principal

amount of the loan along with interest. Funds were thus made available to put in place a developmental infrastructure.

This arrangement allowed A to have a say in how the C property surrounding its purchase was to be developed. A claims significant benefits in having streets, sewers, utilities, and other infrastructure needed for the building site put into place by the developer. If A were to have purchased the C land from the developer in an improved condition, the cost of the property would have been significantly higher.

Of the original x acres of C property purchased from the family, A retained y acres. A sold z acres to a local E group so it could establish a new E organization; the remainder of the acres are being held by A for future use consistent with its charitable purposes.

Subsequent to the completion of C, D project, A entered into two other similar arrangements. One transaction involved the sale of approximately a acres of land. G property was originally purchased for the future development of a new E organization to further J's purposes. However, shortly after A obtained G, an existing building appropriate for A or J's purposes became available in the area. Rather than continue with the process of developing a new building on G, A opted to purchase the existing facility. G was no longer needed for the purpose for which it was originally purchased so it was put up for sale.

G was on the market for approximately three years without any interest from prospective buyers. To make the property more desirable and to maintain control over development in the area, A purchased an adjacent tract of land with a residence. G, including the recently purchased adjacent parcel, was sold to a developer and financed through a deed of trust and a subordinated promissory note. The two tracts of land were purchased for a total of b and sold for c, a gross profit of d.

In the other transaction, A was interested in acquiring an advance site in the vicinity of B, D which has experienced rapid development in recent years. A wanted to construct a new E building and/or an E educational facility in the area as a part of its land purchase program but it was unsuccessful in finding a small parcel of land.

A local family owned approximately x acres of undeveloped land known as H. A only needed e acres yet the family wished to sell all x acres. Consequently, A purchased f acres with the intention of keeping y acres as an advance site.

This left A in the position of having to dispose of the remaining acreage. A listed the property for sale with a broker. A sold h acres to a developer and financed the deal through a subordinated promissory note and a deed of trust comparable to that used to finance G. The developer must repay A the principal amount of the loan along with interest.

Following A's sale of its excess holdings in H, the city of B re-zoned the remaining land that A had in H as a technology friendly zone. This designation rendered the remaining land undesirable to A for E uses and as a consequence, A sold the remaining property for a profit of i.

A has provided a schedule of thirty-eight properties in the last fifteen years that it has purchased, sold, given to new E organizations to further A and J's purposes, held for sale, or held for future use. Of these thirty-eight properties, fourteen properties were transferred to new E organizations, twelve were sold (all transactions were profitable except one), and the remainder were held for future exempt or sales potential. The C, G, and H properties described above are included in this schedule.

REQUESTED RULINGS

A requests the following rulings on A's land purchase program:

1. The sale of C surplus land by A did not result in unrelated business taxable income within the meaning of section 512 of the Code.

2. The use of an equity participation (or shared appreciation) note and a deed of trust to finance the sale of C surplus land to the buyer did not result in unrelated business taxable income.

3. The installation of roads, sewers, sidewalks, utilities, and other infrastructure improvements on C surplus land to support a future E organization site as partial consideration for the sale of the surplus land did not result in unrelated business taxable income.

4. The sale of G along with the augmented adjacent property did not result in unrelated business taxable income.

5. The sale of H surplus land did not result in unrelated business taxable income.

6. The use of a subordinated promissory note with deferred interest with respect to the sale of H surplus land did not result in unrelated business taxable income.

LAW

Section 501(c)(3) of the Code exempts from federal income tax organizations organized and operated exclusively for charitable, educational, scientific, or certain other purposes.

Section 511 of the Code provides, in part for the imposition of tax on the unrelated business taxable income of organizations described in section 501(c) of the Code.

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

Section 512(b)(1) of the Code excludes interest from the definition of unrelated business taxable income.

Section 512(b)(5) of the Code states that all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year or (B) property held primarily for sale to customers in the ordinarily course of the trade or business are not included in the definition of unrelated business taxable income under section 512(a)(1) of the Code.

Section 513(a) of the Code generally defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable or other purpose or function constitution the basis for its exemption under section 501.

Section 513(c) of the Code provides that the term 'trade or business includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.'

Section 1.512(b)-1 of the Regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed 'rent' by the parties is in fact a return of profits by a person operating the property for the benefit of the exempt organization or is a share of the profits retained by such organization as a partner or joint venture, such payment is not within the modification for rents.

Section 1.512(b)-1(d)(1) of the Regulations provides, in part, there shall also be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would be properly included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business.

Section 1.513-1(a) of the Regulations provides, in part, that unless one of the specific exceptions of section 512 or 513 applies, the gross income of an exempt organization subject to the section 511 tax is includible in the computation of unrelated business taxable income if, 1) it is income from a trade or business, 2) such trade or business is not 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(b) of the Regulations states that the term 'trade or business' has the same meaning as in section 162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c) of the Regulations provides in part that a business activity will be deemed to be regularly carried on if it manifests a frequency and continuity, and is pursued in a manner generally similar to commercial activities on non-exempt organizations. Section 1.513-1(d)(2) of the Regulations states that a trade or business is 'related to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is substantially related' for purposes of section 513, only if the causal relationship is a substantial one. Thus for the conduct of 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. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of goods or the performance of services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 55-559, 1955-2 C.B. 599, deals with a charitable foundation which built and sold eighty houses solely to raise funds to support a church. The revenue ruling closes by stating that the construction and sale of houses with all attendant activities is regularly carried on due its extent. Rev. Rul. 59-91, 1959-1 C.B. 215, describes a corporation that sold a portion of its property which has been held as an investment. The property was subdivided into residential lots, graded, the streets surfaced, and the required drainage and utilities were installed. In holding that the gains realized from the sales of the lots constituted ordinary income, the ruling implies that the sizeable improvements made in order to facilitate the sales led to the conclusion that the property was held primarily for sale to customers.

Rev. Rul. 79-349, 1979-2 C.B. 233 holds that 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.

Adam v. Commissioner, 60 T.C. 996 (1973) provides several guidelines to be used to determine whether a taxpayer engaged in a land transaction in furtherance of their trade or business. The Court states that (1) the purpose for which the asset was acquired; (2) the frequency, continuity, and size of the sales; (3) the activities of the seller in the improvement and disposition of the property; (4) the extent of the improvements made ot the property; (5) the proximity of the sale to the purchase of the land; and (6) the purpose for which the property was held during the taxable year are all useful in making this determination.

In Parkland Residential School, Inc. v. Commissioner, T.C.M. 1983-139, a 501(c)(3) organization had as its exempt function the operation of a school for mentally disabled children. The school entered into 22 transactions of simultaneous purchase and sale at a profit of real properties over two years. This resulted in unrelated business taxable income.

In Houston Endowment v. United States, 606 F.2d 77 (5th Cir. 1979), the Court deals with the recurring "conundrum whether property sold by a taxpayer was held primarily for investment or for sale to customers in the ordinary course of business." The criteria used to make a determination are: (1) the substantiality and frequency of sales, (2) improvements, (3) solicitation and advertisement, and (4) broker's activities.

According to the Court in Houston Endowment, the frequency and substantiality of the taxpayer's land sales are the most important criteria. The Court goes on to state that "although a taxpayer may have acquired property without intending to enter the real estate business, what was once an investment or what may start out as a liquidation of an investment, may become something else. [W]here sales are continuous, the nature and purpose of a taxpayer's acquisition of property is significant only where sales activity results from unanticipated, externally introduced factors which make impossible the continued pre-existing use of the realty. Original investment intent is pertinent, for example, when a taxpayer is coerced to sell its property by acts of God, new and unfavorable zoning regulations or other uncontrollable forces."

An additional criterion noted in Houston Endowment is the presence of improvements on the land at issue. The plaintiff's predecessor in interest constructed roads, water lines, sewers, and railroad tracks to enhance the attractiveness of the land to purchasers and to increase the return on the sale of the property. While this criterion is of lesser importance than the substantiality and frequency of sales, it also indicates that the land was held for sale in the ordinary course of business.

ANALYSIS

A has represented that a total of thirty-eight tracts of land either were held or were disposed of through the land purchase program. A has provided a schedule of thirty-eight properties in the last fifteen years that it has purchased, sold, given to new E organization to further A and J's purposes, held for sale, or held for future use. Of these thirty-eight properties, fourteen properties were transferred to new E organizations, twelve were sold (all transactions were profitable except one), and the remainder were held for future exempt use or sales potential.

It is clear that over a fifteen-year period, A has engaged in regularly carried on trade or business primarily contributing importantly to A's exempt purposes. However, section 513(c) of the Code provides for fragmentation of trade or business activities to determine whether there are unrelated components within a larger aggregate of activities that may be related to the exempt purposes of the subject organization. As discussed in the analysis of the rulings below, A has engaged in substantial regularly carried on unrelated trade business as a component of its substantially related land purchase activity.

The requested rulings are discussed in turn below.

1. Sale of C Property

The sale of the C property is analyzed in the fragmentation context under section 513(c) of the Code as it was purchased through A's land purchase program. In 1993, A sought to expand itself in C and became aware of x acres of farmland for sale. The city had been growing at a

substantial rate and the land was one of the largest tracts of undeveloped land remaining. The seller was not interested in selling less than the entirety of its land and A purchased the entire tract. A only needed a part of the acreage for E purposes. The excess land was sold for a profit. Houston Endowment, supra, reasons that the substantiality and frequency of sales indicate a regularly carried on business. C was acquired through that part of fragmentation of A's land purchase program, which, as described in the facts herein and the analysis that follows on A's other issue transactions, indicates substantial and frequent sales of surplus land that is not intended for exempt E use. Further the majority of C was sold shortly after its purchase. Consequently, the sale of C surplus land is unrelated trade or business activity regularly carried on within the purview of section 1.513-1(d)(2) of the Regulations.

Section 512(b)(5) of the Code provides for an exception from the definition of unrelated business taxable income in the case of property sales. However section 512(b)(5)(B) provides that this exception does not apply in the case of property held primarily for sale to customers in the ordinary course of business. The sale of C and other land sales are components of A's unrelated land purchase program. These sales are regular and substantial and are for non-exempt purposes. The primary portion of C was sold shortly after its purchase. The frequency, continuity and size of sales, the extent of improvements, and commercial loan devices in some situations support a conclusion that A holds some property primarily for sale to customers in the ordinary course of trade or business. Consequently, the modification for gains from the sale of property set forth in section 512(b)(5) of the Code and section 1.512(b)-1(d)(1) of the Regulations is not applicable here.

2. Loan to the Developer of C

A lent funds to the developer of C which the latter must repay with interest. A's main activity is fostering the spread of J's purposes in its tradition through outreach work. J's main activity is finding new E members and establishing similar E organizations here in the United States and particularly in D. The developer's main activity is the development of residential land.

In order for an activity to avoid being classified as unrelated trade or business, the activity must be 'substantially related' to the achievement of the organization's exempt purposes. In this case, the loan of funds to the purchaser and developer of C, must contribute importantly to A's activities in fostering the spread of J's purposes. The developer develops residential land. The development of residential land does not contribute importantly to the accomplishment of A's exempt purposes. A's commercial loan is not substantially related to A's exempt activities and, along with the commercial loan described in issue 6 infra, is part of A's regularly carried on land purchase program that is not substantially related to A's exempt activity. A's equity participation loan device is distinguishable from the situation described in Rev. Rul. 79-349, supra. In the latter, the exempt employee plan generated interest income from the making of mortgage loans. In A's situation, the loan device is used as an installment mechanism to sell land. Only the interest component of the transaction would fall into the section 512(b) modification. A's activity generated unrelated taxable business income.

3. Improvements on C Surplus Land as Partial Consideration

As previously discussed, the sale of C property is unrelated trade or business. As part of A's unrelated regularly carried on land purchase program, A sold the land to a developer who installed streets, sewers, utilities, and other infrastructure as partial consideration on the land that A retained. The underlying transaction generated unrelated taxable business income.

4. Sale of G

In 1991, A purchased G property with the intention of erecting a building on the site for the use of a newly formed E organization. Shortly thereafter, an existing building became available in the vicinity of the property A already owned. As a result, the members of the newly formed E organization opted to purchase the existing property and attendant building instead of constructing on the property that A already owned. G was no longer needed so A listed it for sale with a local broker. This property was listed for sale for approximately three years without any takers. In 1996, A purchased an abutting tract of land in order to make it more attractive to potential purchasers. The entire tract of land was sold to a developer one year later.

As discussed, section 513(c) of the Code provides for fragmentation of trade or business activities to determine whether the unrelated components within a larger aggregate of activities may be related to the exempt purposes of the subject organization in section 501(a). The sale of the G property is analyzed in this fragmentation context as it was purchased through A's land purchase program. Houston Endowment, supra, reasons that the substantiality and frequency of sales indicate a regularly carried on business. G was acquired through A's land purchase program which upon analysis indicates substantial and frequent sales of surplus land that is not intended for exempt E use. Consequently, the sale of G surplus land is a regularly carried on unrelated trade or business.

Section 512(b)(5) of the Code provides for an exception from the definition of unrelated business taxable income in the case of property sales. Subsection (B) however goes onto state that this exception does not apply in the case of property held primarily for sale to customers in the ordinary course of business. As with the sale of C, the sale of G is a component of the land purchase program which is marked by the frequent and substantial sale of land, an indicator of a business. Consequently, the exception does not prevent income generated from the sale of G from being classified as unrelated business taxable income.

5. Sale of H

In 1996, A purchased f acres of H property with the intention of using y acres for its exempt activity. To dispose of the excess land, A retained the services of a broker. A sold h acres of H to a limited liability company.

The previously discussed rationale dealing with the frequency and substantiality of the sale of land purchased through the land purchase program applies to this portion of the sale of H as well. The frequency and substantiality of the land sales and the use of a broker are factors elaborated in Houston Endowment, supra. The sale of h acres of H generated unrelated business taxable income.

Following this sale, the city of B, D re-zoned the acres which A retained for its exempt activity as a technology friendly zone. This rendered the acres in the advance purchase site and the acres that A had otherwise retained unusable for its original purposes. A sold the remaining interest it held in the land.

Original investment intent is pertinent to a determination of whether there is unrelated business activity when a taxpayer is required to sell property due to new and unfavorable zoning regulations or other forces uncontrollable by the taxpayer that make the property unusable for its original intended purpose, see Houston Endowment, supra. The sale of p acres of H did not generate unrelated business taxable income.

6. Loan to Developer of H

A lent funds to the developer of H. The developer's main activity is the development of residential land.

In order for an activity to avoid incurring unrelated business income tax for an organization, the activity must be "substantially related" to the achievement of the organization's exempt purposes. In this case, the loan of funds to the purchaser of H must contribute importantly to A's activities in fostering the spread of J's purposes. The developer develops residential land. The development of residential land does not contribute importantly to the accomplishment of A's purposes. As discussed in 2 above, part of A's regularly carried on unrelated land purchase program, A's loan of funds is not substantially related to the accomplishment of A's purposes and it generated unrelated business taxable income.

Accordingly, we rule as follows:

1. The sale of C surplus land by A did result in unrelated business taxable income within the meaning of section 512 of the Code.

2. The use of an equity participation (shared appreciation or limited recourse property appreciation loan promissory) note to sell the C, D property did result in unrelated business taxable income.

3. The installation of roads, sewers, sidewalks, utilities, and other infrastructure improvements on C surplus land to support a future E organization site as partial consideration for the sale of the surplus land did result in unrelated business taxable income.

4. The sale of G along with the augmented adjacent property did result in unrelated business taxable income.

5. The sale of h acres of H surplus land did result in unrelated business taxable income. The sale of p acres of H surplus land did not result in unrelated business taxable income.

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6. The use of a subordinated promissory note with deferred interest with respect to the sale of H surplus land did result in unrelated business taxable income.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited by others as precedent.

Because this letter could help resolve any question about your exempt status, you should keep it in your permanent records.

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

Sincerely,

/S/

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2

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