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

200211052

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEC 20

SIN: -0501.03-25
.O514.06-00

NO THIRD PARTY
CONTACTS

T:EO:4

Employer Identification Number:

Legend:
M =
N =
O =
P =
Q =

Dear Sir or Madam:

This is in response to a letter dated August 9, 2001, in which M and N request rulings regarding unrelated business taxable income under sections 513 and 514 of the Internal Revenue Code and charitable activity under section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations arising out of the activities of P, a limited partnership of which M and N are the sole partners.

N is exempt under section 501(c)(3) of the Code and classified as a public charity described in section 509(a)(1) during an advance ruling period. N describes its activities as follows:

> ...N will invest its assets and make qualifying distributions under section 4942 to accomplish one or more purposes described in sections 170(c)(1) or (2)(B).
>
> Initially, N intends to further its general charitable purposes of promoting social welfare, including, but not limited to lessening neighborhood tensions, eliminating prejudice and discrimination, combating community deterioration and juvenile delinquency, by concentrating its charitable efforts to benefit ....a low income community ... Like most low-income communities, ... has a relatively high crime rate, a higher number of welfare recipients, higher poverty rates and lower school test scores as compared to many other communities ...
>
> To help improve the economic conditions and combat community deterioration ..., N intends to make investments in residential properties (some of which will be low income housing units) and also invest in commercial property in the ... community.

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M is exempt under section 501(c)(3) of the Code and classified as a public charity under section 509(a)(3). M describes its activities as follows:

> M is organized and operated exclusively to support and benefit O, a ... nonprofit public benefit corporation. M's primary activity is to hold, maintain, operate and/or sell real property for the benefit of O, and to pay O all income and gain derived therefrom. M will perform a function that would otherwise be performed by O. The holding of real property separate from O's other assets will allow for the more efficient operation and utilization of such real property and will protect O's other assets from liabilities associated with the ownership of real property. ...

O is exempt under section 501(c)(3) and classified as a public charity described in sections 509(a)(1) and 170(b)(1)(A)(vi). O describes its activities as follows:

> ...to receive gifts, bequests, and life estates to be held in charitable trust and administered on a grant basis for purposes which benefit the people of ...
>
> [O] will administer gifts in any form and for any restricted or unrestricted [purpose], which qualifies under section 501(c)(3) of the Code. Ordinarily, [O] will make allocations to other agencies and institutions on a grant basis for the advancement of health, social welfare, education, cultural and civil improvement purposes. Unrestricted gifts and bequests will be encouraged, but donors may designate particular areas of interest or specific service agencies to benefit from their contributions. Such designations can be altered ... if literal compliance with restrictions becomes impossible, impracticable, unnecessary or undesirable.

M and N are in the process of effectuating a plan to combat community deterioration by (1) rehabilitating existing housing, and developing new housing, and (ii) further stabilizing the area through commercial development. To this end, M and N have formed P, a limited partnership. N is the general partner and M is the sole limited partner. The Partnership Agreement provides, in part, as follows:

1. P shall conduct its activities so as to primarily further the charitable purposes of the partners and not to benefit a private person;

2. P intends to purchase, develop, hold and/or sell real estate in the community in order to accomplish one or more of the following goals: combat community deterioration, provide decent affordable housing, provide low income housing, provide home ownership to families that cannot otherwise afford to purchase safe and decent housing; reduce crime by improving housing, prevent deterioration of the ...neighborhood.

The designated neighborhood is deteriorated and blighted and located in a Redevelopment Project Area under the provisions of the Redevelopment Plan for the City of .... The Redevelopment Plan was approved and adopted by the City Council. The City Council

approved the Plan because it determined that significant physical, social and economic blight still exists within the Project Area and that the Project cannot reasonably be expected to be accomplished by private enterprise acting alone. The City Council further determined that completion of the Project is in the vital and best interest of the City of ... and the health, safety, morals, and welfare of its residents, and in accord with ... public purposes.

N has entered into a Disposition and Development Agreement (DDA) with the Redevelopment Agency of the City, a governmental agency, to be the developer of the Project. The DDA provides for the disposition of the Site... and the development and operation on the Site of a mixed use housing and office building development and related parking.

Pursuant to the DDA, the Redevelopment Agency is to acquire all of the parcels of land which comprise the Site, using its powers of eminent domain, if necessary, and then sell the Site to N for a purchase price equal to the Agency's cost. N is to construct residential units and a commercial building for offices and retail space on the Site. Approximately 30% of the residential units are to be reserved for rental to persons of very low income (income does not exceed 50% of the area median income adjusted for family size appropriate to the unit). The remaining residential units will be sold for little or no profit. The commercial office building is to be leased primarily to tax exempt organizations and governmental agencies that will be in a position to render vital services to the residents of the City. The DDA further provides that the Redevelopment Agency shall subsidize the costs to N related to the acquisition of the Site as well as costs and expenses related to the construction of the residential units by assigning a portion of funds the Agency receives from taxes.

N has assigned the DDA to P which will own and develop the Project. P has acquired the fee title to the Site and started construction. P has purchased and will, in the future, purchase deteriorated single and multi-family residences located in the blighted area for the purposes of renovating and leasing and/or selling them for little or no profit. P also intends to purchase and redevelop commercial properties in the blighted area for both commercial and residential purposes. Priority will be given to persons living or working in the area with respect to the sale and leasing of all residences.

P intends to apply for loans from Q, a government agency, that raises funds through tax-exempt financing. If tax exempt financing is not available, P will apply for loans that are not raised through tax exempt financing. All of the funds will be used toward Project activities.

Based on these facts, you have requested the following rulings:

1. P's activities will be considered as furthering the charitable purposes of N and M within the meaning of section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations.

2. P's activities will not be considered an unrelated trade or business under section 513(a) of the Code.

3. Income received by N and M through P from these activities, including, but not limited to:

rental income, property management fees and income from the sale of residential and commercial properties, will not be subject to unrelated business income tax under section 511 of the Code whether or not there is any "debt financed property," as defined in section 514.

Section 1.501(c)(3)-1(d)(2) of the regulations defines the term "charitable" in its generally accepted legal sense and it is not limited by the separate enumeration of exempt purposes in section 501(c)(3) of the Code. The term includes, inter alia, relief of the poor and distressed; lessening of the burdens of government; and promotion of social welfare by an organization designed to do any of the above or combat community deterioration, or lessen neighborhood tensions.

Combating community deterioration in the "charitable" sense involves remedial action leading to the elimination of the physical, economic and social causes of such deterioration. Thus, Rev. Rul. 70-585, 1970-2 C.B. 115, Situation 3, holds that an organization that plans for the renewal and rehabilitation of a residential community in a blighted area qualifies for exemption under section 501(c)(3). Similarly, Rev. Rul. 74-587, 1974-2 C.B. 162, holds that an organization formed to provide low-cost financial assistance to business enterprises in an economically depressed area qualifies for exemption under section 501(c)(3).

The establishment or promotion of business in economically depressed areas by an organization pursuant to a government program is another form of remedial action which is considered charitable. For example, Rev. Rul. 76-419, 1976-2 C.B. 146, holds an organization which purchased blighted land in a depressed area and converted it to an industrial park, leasing the land to tenants who employed significant numbers of unemployed, who lived in the area, and trained these unemployed in needed skills, qualifies for exemption under section 501(c)(3). The organization received its funding pursuant to a public law providing for the establishment of special programs having an impact on such low-income areas.

Section 511 of the Code imposes a tax on unrelated business taxable income of organizations exempt from federal income tax under section 501(c)(3).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by an organization from an unrelated trade or business regularly carried on by it, less the deductions directly attributable to such business activity.

Section 512(b) of the regulations excludes certain types of income from the definition of unrelated business taxable income including (but not limited to) dividends, interest, and rents from real property. However, if the income is derived from debt-financed property [section 514] or controlled organizations [section 512(b)(13)] it will be included in the computation of unrelated business taxable income.

Section 1.512(c)-1 of the regulations provides that if a trade or business is regularly carried on by a partnership of which a tax exempt organization is a partner and is an unrelated trade or business with respect to the organization, then the organization must include its share (whether or not distributed) of the gross income of the business and its share of partnership deductions

directly connected with the gross income in its computation of unrelated business taxable 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 such organization for income or funds or the use it makes of profits derived) to the exercise or performance by such organization of the purposes or function constituting the basis for its exemption. Section 1.513-1(d)(2) of the regulations provides that a trade or business is substantially related to exempt purposes when the business activity has a substantial causal relationship to the achievement of the exempt purposes.

Section 514(a)(1) of the Code provides that income from "debt-financed property" that is not related to the organization's exempt function is included as unrelated business taxable income.

Section 514(b)(1) defines debt-financed property as any property which is held to produce income with respect to which there is acquisition indebtedness. Section 514(c)(1) provides, in part, that "acquisition indebtedness" means the unpaid amount of the indebtedness incurred by an organization in acquiring or improving the property.

Section 514(b)(1)(A) provides that any property all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by the organization of its charitable purpose will not be included in the term debt-financed property.

Based on the facts represented, N and O were formed for the purpose of and are directly involved in projects designed to further social welfare through the relief of the poor and distressed, lessening the burdens of government, combating community deterioration and lessening neighborhood tensions. M, as a supporting organization of O, was created for the purpose of furthering O's exempt purposes. By working together through P in undertaking the Redevelopment Project described above, both N and M will continue to combat community deterioration and further the social welfare of the blighted community in the same manner as the organizations described in Rev. Ruls. 70-585, supra, 74-587, supra, and 76-419, supra. Accordingly, P's activities will be considered as furthering the charitable purposes of N and M within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations.

Since P's activities further exempt purposes, they are not "unrelated trade or business" within the meaning of section 513(a) of the Code and section 1.513-1(d)(2) of the regulations. Income received by N and M through P will not be taxable under section 511.

Income received by N and M through P , including, but not limited to: rental income, property management fees and income from the sale of residential and commercial properties, constitutes income from the use of property which is substantially related to the organizations' exempt purposes. Therefore, under section 514(b)(1)(A) of the Code this property is not included in the term debt-financed property.

Based on the above facts, we rule as follows:

1. P's activities will be considered as furthering the charitable purposes of N and M within the meaning of section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations.

2. P's activities will not be considered an unrelated trade or business under section 513(a) of the Code.

3. Income received by N and M through P from these activities, including, but not limited to: rental income, property management fees and income from the sale of residential and commercial properties, will not be subject to unrelated business income tax under section 511 of the Code whether or not there is any "debt financed property," as defined in section 514.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

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

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,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

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