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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend

Council =
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X =
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Dear Sir or Madam:

This letter responds to the request of attorneys for Council, dated April 10, 2001, for rulings regarding the federal income tax consequences of the proposed transaction described below under sections 501(c)(3), 512(a), and 513(a) of the Internal Revenue Code ("Code").

Council is a State nonprofit corporation, which was formed over ten years ago to promote community and economic development in County. Council is exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3) and is classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(vi). The Board of Directors of Council is composed of both city and county officials, including the mayors of the cities of X and Y, both located in County, the County Commissioner, the County Executive, and independent members of the community.

Since its formation, Council, a partnership of local government and the private sector, has conducted community and economic development projects for County, State. County is a rural county with a population less than 40,000. County is plagued by stagnant job growth and low per-capita income. The general education level of County is below the state average. The opportunity for business expansion in County is constrained by its largely unskilled, undereducated workforce. County has had chronic unemployment for several years. Based

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upon income and education statistics, the residents of County typically have ranked below other counties in State.

For instance, County had the highest unemployment rate among all counties in State for the year 2000. This was during a period when State's unemployment rate had dropped to one of its lowest annual jobless rates and was below the national average. Also, County has been designated a "Labor Surplus Area" by the United States Department of Labor. To be designated as a Labor Surplus Area, the county must have an unemployment rate of at least 20% above the national average for the previous two calendar years.

The State Department of Economic and Community Development ("Department') annually designates economically distressed counties for special consideration in various economic development incentive programs administered by State (a "Special Enhancement County"). Such counties are considered to have severe economic problems and to which State wants to offer special consideration in future economic development activities. These designations are based on a county being among the ten "worst" in State based on one of the following factors: unemployment, per capita market income, or poverty. In addition, the Commissioner of Department has the discretion to designate a county as a Special Enhancement County based on other distressed factors. As a result of its high unemployment and other distress factors, the Department has designated County as a "Special Enhancement County."

One of Council's stated missions is to promote the creation of jobs for the citizens of County and the development of new business and industries and the retention and expansion of existing businesses and industries within County. Also, Council has focused on educational projects for building a well-trained workforce in County attractive to new and existing business and industry. Council has partnered with both University and College to bring educational services to the residents of County. Council has recently partnered with State Technology Center to improve classroom/lab facilities.

Council primarily receives its financial support from County government and the incorporated cities in County. Council also receives financial support from local citizens, local businesses and industries, and certain projects developed by Council.

Council has been devoting its resources to programs to stimulate economic development in County. Council serves County in recruiting new industry as well as serving existing industry. For example, Council previously secured federal and state grants and coordinated local matching funds to build a speculative industrial building in County to attract industry and retain current employers, and provide assistance to existing businesses so that they may remain in County.

Due to the high unemployment in County and Council's goals for industrial recruitment and retention to create jobs in County for the unemployed and underemployed, Council proposes to develop and construct certain industrial buildings in County to attract businesses as potential tenants of industrial buildings. Industry sectors targeted for recruitment include: transportation equipment, metal fabricating, plastics, warehouse and distribution, printing and publishing. Council has a planned strategy for recruiting businesses to these sectors, including, among others, targeted advertising, networking with all local, regional, and state economic development organizations, prospecting trips, and trade show attendance. Council has had

previous success with a prior industrial speculative building and would like to continue this effort.

Specifically, to accomplish these additional industrial projects, Council would acquire title to certain land by way of a gift from the City X or from another supporting governmental entity. County will provide a grant to Council to enable it to begin construction of the industrial project. The balance of the industrial project financing would come from funds to be provided by a bank. Upon completion of the industrial project, Council would lease the industrial building to an industrial tenant on a long-term basis with a possible option to purchase. Council will set the lease payments at an amount at least sufficient to amortize the bank loan. It is anticipated that the lease payment will be at fair market value. The bank will be granted a mortgage on the industrial project and will receive an assignment of the payments made pursuant to the lease agreement between Council and the industrial tenant. Any funds derived from Council in the development, construction, ownership and leasing of the proposed industrial building not used to pay the bank loan will be used by Council towards furthering its mission of promoting the creation of jobs for County and the development of new, and the retention of current, businesses.

You have requested the following rulings:

1. The development, construction, ownership and leasing of the proposed industrial building will not adversely affect the Council's tax-exempt status under section 501(c)(3) of the Code.

2. The development, construction, ownership and leasing of the proposed industrial buildings will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code.

3. The gross income generated by the leasing of the proposed industrial buildings will not constitute unrelated business taxable income within the meaning of section 512(a) of the Code.

Section 501(c)(3) of the Code provides, in part, for an exemption from federal income tax for corporations organized and operated exclusively for charitable, scientific or educational purposes.

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

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means, with certain modifications provided in subsection (b), the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions.

Section 512(b) of the Code provides that all rents from real property are excluded from the term "unrelated business taxable income" except in the case of amounts derived from debt-financed property (as defined in section 514).

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Section 513(a) of the Code defines the term "unrelated trade or business" in the case of any organization subject to the tax imposed by section 511, 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 exempt functions

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations ("regulations") provides that the term "charitable' is used in section 501(c)(3) of the Code in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is, with certain exceptions, includable 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(b) of the regulations provides that the term "trade or business" has the same meaning it has in section 162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(d)(1) of the regulations provides that gross income is derived from "unrelated trade or business" within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities that generate the particular income in question — the activities, that is, of producing or distributing the goods or performing the service involved — and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides 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 any exempt purpose, and is "substantially related" for purposes of section 513 of the Code, 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 for which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 514(b)(1) of the Code provides that the term "debt financed property" does not include any property substantially 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 such organization of its charitable purpose.

Section 1.514(b)-1(b) of the regulations states that the principles applicable in determining whether the use of any property is substantially related to the exempt purpose of the organization are contained in section 1.513-1.

In Rev. Rul. 74-587, 1974-2 C.B. 162, an organization was formed for the relief of poverty, the elimination of prejudice, the lessening of neighborhood tensions, and the combating of community deterioration in certain economically depressed areas through a program of financial assistance and other aid designed to improve economic conditions and economic opportunities in these areas. In furtherance of these objectives, the organization devoted its resources to programs designed to stimulate economic development in high-density urban areas inhabited mainly by low-income minority, or to other disadvantaged groups. The organization made loans and purchased equity interests in businesses unable to obtain funds from conventional sources because of financial risks associated with their location and/or because of being owned by members of a minority or other disadvantaged group. The organization qualified for exemption under section 501(c)(3) of the Code.

In Rev. Rul. 76-419, 1976-2 C.B. 146, a nonprofit organization was formed with the objectives of the relief of poverty, dependency, chronic unemployment, and underemployment, and the reduction of community tensions in an economically depressed community. In furtherance of these purposes the organization encouraged industrial enterprises to locate new facilities in the economically depressed area in order to provide more employment opportunities for low-income residents. The organization purchased blighted land in the depressed area and converted it into an industrial park. Lots in the industrial park were leased to industrial enterprises on terms sufficiently favorable to attract tenants to the area. Tenants were required by their lease with the organization to hire a significant number of presently unemployed persons in the area and to train them in needed skills. The organization in selecting tenants for the industrial park, considered only those industrial enterprises whose hiring policies conformed to current fair employment law. Enterprises that had initial requirements for low skill workers were favored over those with initial high skill job requirements, since the former were of greater immediate benefit to the surrounding depressed community. The area in which the organization was active had been identified by governmental authorities as having a high ratio of unemployed and underemployed low-income people.

By inducing industrial enterprises to locate in an economically depressed area, Council is similarly devoting its resources to uses that benefit the community. The types of businesses Council seeks to attract to the industrial park are those that favor low skilled workers, since such jobs are of greater immediate benefit to the surrounding depressed County. This, in turn, will promote the creation of jobs for the citizens of County and will promote the development of new businesses and industries and expansion of existing businesses and industries within County. Similar to the organization in Rev. Rul. 76-419 above, the Council's activities, including the proposed development, construction, ownership and leasing of the industrial buildings, will serve not only to relieve poverty (through the creation of new jobs in County), but also to lessen community tensions caused by the lack of jobs and job opportunities in the area. Council's

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activities, by creating an industrial park out of a blighted area, are combating community deterioration as well. Therefore, this activity will not affect Council's exempt status under section 501(c)(3) of the Code.

Moreover, since the leasing of the proposed industrial buildings will be substantially related to Council's exempt purposes, the property will not constitute "debt financed property" within the meaning of section 514 of the Code, even though debt will be incurred by Council in the construction process. Therefore, the gross income derived by Council from leasing the buildings to commercial tenants will not be unrelated business taxable income, because it will be excluded under section 512(b)(3) as rents from real property.

Accordingly, based on the information and representations submitted, we are ruling as follows:

1. The development, construction, ownership and leasing of the proposed industrial building will not adversely affect the Council's tax-exempt status under section 501(c)(3) of the Code.

2. The development, construction, ownership and leasing of the proposed industrial buildings will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code.

3. The gross income generated by the leasing of the proposed industrial buildings will not constitute unrelated business taxable income within the meaning of section 512(a) of the Code.

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

This ruling is limited to the applicability of the provisions of sections 501(c)(3), 512(a), and 513(a) of the Code, and does not purport to rule on any facts that were not represented in the ruling request as supplemented or on any changes of those facts. This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

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,

Robert C. Harper Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3