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TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

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

200237027

Date: JUN 18 2002

Contact Person:

Identification Number:

Telephone Number:

T:ED:B4

Employer Identification Number:

LEGEND

M =
N =
O =
x =

Dear Sir or Madam:

This is in response to a ruling request dated January 15, 2002, submitted on behalf of M requesting a ruling on the proper treatment of the proceeds of a proposed sale of a portion of M's property under section 512(a)(1) of the Internal Revenue Code.

STATEMENT OF FACTS

M is a religious corporation that is an affiliated member of N. M is an affiliated congregation of N and is included in N's group exemption. As such, M is exempt from federal income tax as an organization described in section 501(c)(3) of the Code.

M acquired all of its property when it was founded more than years ago. Since that time, M has used the property solely in connection with its charitable purposes. M maintains the church along with a related school located on M's property. The property has never been developed or used to produce income. The property has an existing mortgage, which was incurred to make renovations to the school and begin excavation for a gymnasium.

M has contracted to sell a portion of its property in order to raise the funds needed for the construction of a gymnasium for the students attending the school. M has entered into a contract of sale (and two riders) with O, under which M will sell to O a portion of its real property. M has owned the portion of the property that is the subject of the proposed sale since the time of its founding, and since that time, the land has been a part of the church and school grounds. Under the terms of the contract with O, M will receive compensation as follows:

i) 2x in cash at the closing;
ii) 3x in the form of a non-interest bearing promissory note from O to be secured by a mortgage on the property sold; and,
iii) 42% of any net profits from the sale of any improvements made by O to the property.

M has obtained the required state government and court approval of the sale. The Court Order requires that the proceeds of the transaction be used for the construction of the gymnasium and also mandates the satisfaction of the existing mortgage.

RULING REQUESTED

M seeks a ruling that the transaction described above for the proposed sale of real property will not result in the imposition of unrelated business income tax under section 512(a)(1) of the Code, because the income, derived at the time of closing and any subsequent income derived from profits, are excluded from such tax under section 512(b)(5).

LAW AND ANALYSIS

Section 511 of the Code imposes a tax on the unrelated business taxable income of exempt organizations, including those described in section 501(c)(3).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed 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)(5)(B) of the Code excludes from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than property held primarily for sale to customers in the ordinary course of the trade or business.

Section 512(b)(4) of the Code provides, in part, that notwithstanding section 512(b)(5),

in the case of debt-financed property (as defined in section 514) there shall be included as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1).

Section 514(a)(1) of the Code provides, in part, that in computing under section 512 the unrelated business taxable income, there shall be included a certain percentage of income with respect to each debt-financed property.

Section 514(b)(1)(A) of the Code defines the term "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness, other than any property substantially all the use of which is substantially related to the exercise or performance by such organization of its charitable, educational or other exempt purpose.

Section 514(c)(1)(A) of the Code defines the term "acquisition indebtedness" as the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property.

In Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Supreme Court defined the standard to be applied in determining whether property is held "primarily" for sale to customers in the ordinary course of business for purposes of section 1221 of the Code. The court interpreted the word "primarily" to mean "of first importance" or "principally." By this standard, ordinary income would not result unless a sales purpose is of first importance.

In Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. He decided to sell the land and subdivided it into lots, cut in streets, installed storm sewers, constructed gas and electric lines and other activities of the kind usually carried out by a real estate development company. Each year 20 to 30 lots were sold. The court held that the taxpayer was holding lots for sale to customers in the regular course of business. The fact that he did not buy additional land did not prevent the sales activities from being a business as he had enough land for a business without buying more.

Rev. Rul. 55-449, 1955-2 C.B. 599, states that the construction and sale of 80 houses by a foundation otherwise exempt under section 501(c)(3) of the Code over a period of 18 months for the sole purpose of raising funds for the support of a church constitutes unrelated trade or business within the meaning of section 513, notwithstanding the fact that the organization did not plan to engage in further similar activities.

Factors that have been considered by the courts in determining whether the sale of property has been carried out in the regular course of the taxpayer's business are:

1. the purpose for which the property was acquired;
2. the frequency, continuity and size of sales;
3. the extent of improvements to the property;
4. the activities of the owner in improving and disposing of the property;
5. the purposes for which the property is held; and,
6. the proximity of purchase and sale.

As an organization described in section 501(c)(3) of the Code, M is subject to section 511 regarding the imposition of tax on its unrelated business income. M has contracted to sell a portion of its property for the purpose of raising funds needed for the construction of a gymnasium for the students attending the school. The question presented by M is whether the amounts it derives at the time of the closing, together with subsequent amounts derived from profits, may be excluded from the computation of unrelated business taxable income as gain from the sale of property under section 512(b)(5). In determining whether this modification is applicable in this case, the factors listed above must be considered.

M proposes to sell property, which it has held for many years, and which has been used in connection with its exempt purpose. As set forth above, M will receive 2x in cash at the closing, 3x in the form of a non-interest bearing promissory note from O to be secured by a mortgage on the property sold, and 42% of any net profits from the sale of any improvements made by O to the property. M has represented that it will not engage in any activities normally associated with real estate development. M has not subdivided the property, has not made any improvements and will not advertise or solicit bids in connection with the potential future development of the property. Under these circumstances, with respect to the 2x in cash and the 3x in the form of a note secured by a mortgage, the proposed transaction will not result in unrelated business taxable income under section 512(a)(1) of the Code because these amounts will constitute gain from the sale of property under section 512(b)(5).

At this time we are expressing no opinion as to any tax consequences attendant to M's receipt of a percentage of net profits from the sale of improvements made by O to the property.

With regard to the issue of debt-financed property under section 514 of the Code, M represents that the current mortgage was incurred in order to begin the preliminary work on the gymnasium (i.e. to pay for the services of an architect, etc.) which will be built on the remaining property near the school. Section 514(b)(1)(A) defines debt-financed property as any property which is held to produce income and with respect to which there is acquisition indebtedness, other than property substantially all the use of which is substantially related to an organization's exempt purpose. Here, the indebtedness in question was incurred by M to begin the process whereby a gymnasium for the use of its school's students would be built. As the gymnasium would be substantially related to

M's exempt purpose, the existing property on which the mortgage was placed does not constitute debt-financed property. Accordingly, the current mortgage does not affect the application of section 512(b)(5) to the proposed sale. Furthermore, we note that the Court Order limits the use of the proceeds to the construction of the gymnasium and also mandates the satisfaction of the existing mortgage.

RULING

Based on the facts and information submitted and the representations made, we conclude that:

M's proposed sale of real property to O will not result in the imposition of unrelated business income tax under section 512(a)(1) of the Code because the amount of 2x at the closing and 3x in the form of a non-interest bearing promissory note from O will be excluded from the computation of such tax under section 512(b)(5).

The treatment of the 42% of any net profits from any improvements made to the property by O will be the subject of future correspondence.

Except as specifically ruled upon above, no opinion is expressed concerning the federal tax treatment of the transaction described above under any other provision of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative. You should keep a copy of this letter in your permanent records.

This letter 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, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

(signed) Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4