SIN:
501.03-08
512.00-00

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

200243056

Date: AUG - 2 2002

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

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Dear Sir or Madam:

We have considered your request for rulings regarding the federal income tax consequences of the proposed sales of leased fee interests in certain properties as described below.

FACTS:

You are a charitable trust that is exempt under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3), and classified as other than a private foundation under sections 509(a)(1) and 170(b)(1)(A)(ii).

You were created under the will of A, who devised inherited lands to establish and support you. You were created as a means to establish schools to provide formal

education for the people of B. In the will, A directed your trustees to invest the estate to provide income for the maintenance of the schools. The will also directed the trustees to sell property only when, in the opinion of the trustees, a sale may be necessary for the establishment or maintenance of the schools, or when a sale is in the best interest of the estate. In accordance with the directions of the will, you have traditionally endeavored to maintain the land you were bequeathed in order to produce rental income to support the educational purposes for which you were founded. From time to time property has been sold and you have received a number of private letter rulings concerning these transactions.

Today, you have an enrollment of students from preschool through Grade 12 at sites throughout the State of B. Families currently pay in tuition only a small percentage of the cost of educating each student, with more financial aid available to students who demonstrate additional need. In addition to your campus-based day and boarding educational programs, you are also engaged in summer programs, educational partnerships, and other programs that are "outreach related" and intended to provide educational opportunities to a greater population of the people of B.

The schools' educational programs are supported only insignificantly by tuition and almost entirely by your investment income. You earn investment income in the form of rents from your portfolio of real property, consisting of the original bequest and other property acquired for investment purposes, and in the form of income from other investments.

However, you have been liquidating your residential leasehold property as a result of changes in state law compelling such sales. Originally, you owned the leased fee interest in approximately w single-family houselots, and approximately x multifamily units in low rise and high-rise condominium projects, planned unit developments (a type of subdivision with lots and shared common areas ("PUDS")), and cooperative housing projects (collectively, "multifamily units"). Of these original holdings, you currently own the leased fee interest in approximately y single-family houselots and approximately z multifamily units.

Generally, all of the lands converted to single-family subdivisions and multifamily projects are legacy lands that were acquired by you under A's will and estate. None of the lands were acquired for the specific purpose of selling them. You represented that you have not incurred any debt associated with the properties. You have maintained a passive role as lessor over these properties, receiving set rent for the initial term, and then reset rent generally based on the fee simple market values of the underlying land, exclusive of improvements. You have used this rental income to support the schools.

In recent years, the State of B has changed its policy towards ownership of land.

Legislation provides that the State can use its power of eminent domain to condemn residential leasehold property, which it then resells to homeowners. The price paid by the State for the condemned property is based on its current rent, which, in the case of long-term leases, is frequently well below market values. There is legislation that limits the amount of rent charged to lessees of certain residential land and also effectively limits the price received when the land is condemned in that the condemnation price is based upon the reduced rent.

Although you have traditionally endeavored to keep and maintain the land that you were bequeathed in order to produce rental income, the trustees have determined that it is no longer in your best interest to continue holding the single-family and multifamily residential properties. You therefore intend to liquidate the leased fee interest in such properties by offering them for sale to current lessees, the condominium and PUD associations, the cooperative housing corporations, or possibly to third parties.

The trustees have determined that it is necessary to sell the investment in the residential properties for a number of reasons. One is the potentially adverse consequence from the laws relating to the leasing, condemnation and sale of your leased fee interest in the properties to lessees. In addition, as part of a closing agreement entered into with the IRS, you adopted C and D to ensure an endurable and sustainable endowment to carry on the educational purposes. The properties are part of the collective group of assets needed to meet the E objectives in order to adhere to D. Standing alone, the residential properties do not meet your E objectives, and effectively dilute your rate of return for the endowment assets. Finally, your trustees support B's initiative and public policy of increasing individual ownership of residential properties in B, consistent with their fiduciary obligations to carry out the intent of the will of A.

You propose to sell approximately 82 percent of the remaining y houselots in which you currently have a leased fee interest. Approximately 80 percent of the single-family houselots you wish to sell are in development tracts that are subject to the condemnation provisions of the state statute. You will hire an appraiser to assist in developing an updated price list. Generally, you have not made any improvements to the single-family lots. You plan on excluding approximately 18 percent of the houselots in which you currently own the leased fee interest. These excluded properties are in different subdivisions located in regional areas that are largely agricultural and currently economically depressed. You believe that you may recognize greater capital appreciation on these properties by continuing to hold such properties until a developer is willing to purchase the properties as part of a possible replanning of the regional areas. Alternatively, you may use a portion of the lands for educational purposes in the future.

You would like to sell your leased fee interest in approximately 96 percent of the remaining z multifamily units. You will hire outside appraisers to assist you in developing an updated price list. You will retain the leased fee interest in one condominium project. This multifamily project has unique characteristics that may allow for eventual nonresidential use. Also, this project produces current annual rental income that is of a higher than average rate of return.

Your leased fee interests in most of the multifamily units being converted are subject to the mandatory conversion ordinance. Lessees in some of the condominium projects have requested that the city commence the condemnation process to acquire your leased fee interest in certain units of the projects. You anticipate that just compensation to be paid for your leased fee interest should not be lower than your estimate of the market value of the leased fee properties.

You previously received a private letter ruling that the sales of leased fee interests in single-family houselots to current lessees do not adversely affect your exempt status and the income from such sales does not result in unrelated business taxable income. You also previously received a private letter ruling that the sales of leased fee interests in multifamily units to current lessees do not affect your exempt status, and that such sales do not result in unrelated business taxable income.

The trustees will evaluate each property to determine the most efficient method of disposition so that you are able to conduct the sales in a manner that maximizes your return on the investment. As a result, some of the single-family properties and multifamily properties may be sold to current lessees. You may offer to sell leased fee interests in multifamily projects to the respective condominium associations, the PUD associations, or the cooperative housing corporation. The leased fee interest in these units would be offered to the association for the project in which the units are located. Under current law, you must offer the condominium associations the right of first refusal to purchase the leased fee interest in the multifamily units located within each of the respective condominium projects before such leased fee interests may be sold to a third party.

You plan to offer to sell to third parties your leased fee interest in the single-family houselots that have not been sold to current lessees. Similarly, you plan to offer to sell to third parties your leased fee interest in the multifamily units that have not been sold to current lessees, condominium or PUD associations, or the cooperative housing corporation. If necessary, you will sell in bulk.

You will engage a national business consulting firm to conduct a market analysis and to assist you in developing a residential sales strategy for the residential property.

You may employ marketing assistance for potential sales to third parties, particularly if national markets are identified as targets for potential purchasers. You may engage brokers to assist with sales of property to third parties. Brokers will likely be engaged if bulk sales appear necessary.

You have requested the following rulings:

1. Whether the bulk sales of the leased fee interests in multifamily properties to the respective condominium or PUD associations, or to the cooperative housing corporation, will adversely affect your exempt status as an organization described in section 501(c)(3) of the Code, or generate unrelated business taxable income under sections 511-513.

2. Whether the sales of your leased fee interests in single-family or multifamily properties to third parties will adversely affect your exempt status as an organization described in section 501(c)(3) of the Code or generate unrelated business taxable income under sections 511-513.

APPLICABLE LAW:

Section 501(c)(3) of the Code describes as exempt from federal income tax, as provided under section 501(a), organizations organized and operated exclusively for, among others, educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the Income Tax Regulations defines private shareholders or individuals within the meaning of section 501 as persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages 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(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of designated individuals, the creator or his family, shareholder of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(e)(1) of the regulations provides, in part, that an organization

may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in section 513.

Section 511 of the Code imposes a tax on the unrelated business taxable income of certain tax-exempt organizations, including charitable and educational organizations 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 (as defined in section 513(a)) regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business computed with the modifications provided in section 512(b).

Section 512(b)(5) 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 (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 ordinary course of the trade or business.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business of an organization subject to the tax on unrelated business income 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 its exempt function, subject to certain exceptions.

In Malat v. Riddell, 383 U.S. 569 (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. 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 dominant.

DISCUSSION:

The facts presented in your ruling request establish that you will continue to engage primarily in the provision of education services. Therefore, you will continue to engage primarily in activities that accomplish exempt educational purposes, and no substantial part of your activities will be in furtherance of nonexempt purposes, as required by section 1.501(c)(3)-1(c)(1) of the regulations. In addition, nearly all of the funds generated by you are devoted to the conduct of your education programs,

satisfying the requirements set forth in section 1.501(c)(3)-1(e). In view of the foregoing, your proposed sale of property will not affect your qualification for recognition of exemption under section 501(c)(3) of the Code.

You propose to sell land that you received by bequest and have held for a significant period of time. This is contrary to the short turn around period experienced by a typical commercial buyer and seller of real estate.

None of the lands were acquired for the specific purpose of selling them, and since the time the lands were acquired, past liquidations generally occurred only for the reason that it was not in your best interest to continue holding the property. You now wish to liquidate your leased fee interest in the land for similar reasons. Based upon the likelihood that state and local law will prevent you from preserving the value of the land as an investment, and your need to meet your E objectives, you have determined that it is in your best interest to sell the land now.

Generally, you have made no improvements to the properties. You did not manage the properties. You held the lands for investment purposes, in order to provide income for the educational programs of the schools. You will attempt to sell the properties to the current lessees or the condominium or PUD associations or the cooperative housing corporation. If this is not successful, you will sell to third parties. These facts distinguish the proposed transaction from the sale of property held primarily for sale to customers in the ordinary course of business. Applying the facts and circumstances test of Malat v. Riddell, supra, we have concluded that this transaction does not involve property held primarily for sale to customers in the ordinary course of business. Therefore, income from the sale of the properties is excluded from the computation of unrelated business taxable income by reason of section 512(b)(5) of the Code.

CONCLUSIONS:

Accordingly, we rule as follows:

1. Your bulk sales of the leased fee interests in multifamily properties to the respective condominium or PUD associations, or to the cooperative housing corporation, will not adversely affect your status as an organization described in section 501(c)(3) of the Code and will not generate unrelated business taxable income.

2. Your sales of the leased fee interests in single-family or multifamily properties to third parties will not adversely affect your status as an organization described in section 501(c)(3) of the Code and will not generate unrelated business taxable income.

This ruling is based on the understanding that there will be no material change in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service.

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 as precedent.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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. Because this letter could help resolve future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

We have sent a copy of this letter to your representative as indicated in your power of attorney.

Sincerely,

Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1