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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

UIL Numbers: 512.00-00
514.06-00

Date: FEB 20 2003

Contact Person:

Identification Number:

Telephone Number:

T:EO:B3

Employer Identification Number:

Legend:

Foundation =
Engineering =
Memorial =
Medical =
Title Holding =
University =
Research Center =

Dear Sir or Madam:

This is in reference to your ruling request dated November 12, 2001, concerning the proper tax treatment, under sections 511-514 of the Internal Revenue Code ("Code") of the proposed transaction.

The Foundation, Engineering, Memorial and Medical are all exempt from federal income tax under section 501(a) of the Code as organizations described in section 501(c)(3) and Foundation is a private foundation within the meaning of section 509(a). The Foundation's principal activity is to make distributions annually to a division of the University, to fund research programs for the study of Parkinson's disease and other central nervous system disorders. Engineering's principal activity is to make distributions annually to a division of the University. Memorial's principal activity is to make distributions annually to educational, cultural, community and charitable organizations that qualify as exempt organizations under section 501(c)(3). The Foundation is Medical's sole member. Medical's principal activity will be to form and operate a medical college located near the University. The Foundation, Engineering, Memorial and Title-Holding have the same directors and the same foundation manager. Foundation has the power to appoint and remove all the directors of Medical.

Title Holding is exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(2). Title Holding is organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to the Foundation. Foundation has the power to appoint and remove Title Holding's directors. Title Holding, is a newly formed corporation and it has represented that it will file consolidated federal tax returns with the Foundation beginning with its first tax return year.

In order to provide the residents of the state in which the University is located, particularly residents of the largely rural counties of that state, with access to quality medical care, Medical intends to form and operate a medical college near the University (the "Medical College"), and to provide graduate medical education, as well as research and clinical education, to enrolled students. The Medical College will be a state and nationally accredited institution affiliated with the University. The Medical College and the University will enter into a collaboration agreement, which will provide, among other things, that the president of the University shall designate one director of the Medical College. The proposed collaboration agreement was submitted with the private letter ruling request. Pursuant to the bylaws of the Medical College, the board of directors will consist of at least five, but not more than ten, persons all of whom are appointed by the Foundation, except as noted above.

Title Holding will acquire real property, through a ground lease. Title Holding will lease the land from Research Center, a related entity of the University and a publicly supported exempt foundation described in section 501(c)(3) of the Code. Such lease will provide for fair market value rental payments (including an adjustment based upon the Consumer Price Index). Title Holding will, in turn, lease the property to Medical at fair market value rates, and such property will be used by Medical in furtherance of its exempt purposes, as stated above. Title Holding has represented that it will distribute its net profits to the Foundation.

Title Holding will hire an independent corporation whose function will be to construct a building and related improvements necessary to house the Medical College, and the personal property (i.e., desks, chairs, computers) necessary to operate the Medical College. The land and improvements to be constructed thereon are referred to as "Property". Title Holding will, on arm's length terms, borrow funds from one or more banks and the corporation will construct the building and related improvements on the leased land. Engineering and/or the Foundation and/or Memorial will guarantee the loan. The loan will also be secured by a deed of trust encumbering the personal property and the leasehold estate in the real estate.

The personal property necessary to operate Medical will be separately acquired by Medical. Medical, on arms length terms, will borrow the funds necessary to acquire the personal property from the Foundation and/or Engineering and/or Memorial.

The Foundation and/or Engineering and/or Memorial may advance funds to Medical for initial operating or capital expenditures necessary to operate the Medical College. Any such debt will not be secured, and may be cancelled in whole or in part.

Title Holding has requested the following rulings:

1. The Property leased by Title Holding to Medical will not be "debt-financed property" within the meaning of section 514 of the Code; and

2. Title Holding will not have unrelated trade or business taxable income under section 514(a) of the Code as a result of the transactions described above.

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(a) ("UBTI").

Section 511(c) of the Code provides a special rule for 501(c)(2) corporations. That section states that, if a corporation described in section 501(c)(2) — (1) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or which would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and (2) such corporation and such organization file a consolidated return for the taxable year, such corporation shall be treated, for purposes of the tax imposed by subsection (a), as being organized and operated for the same purposes as such organization, in addition to the purposes described in section 501(c)(2).

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)(3) 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).

Section 512(b)(4) of the Code provides that notwithstanding section 512(b)(3), 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), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

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 514(a) of the Code provides for the inclusion in gross income derived from unrelated trade or business a percentage of the income derived from debt-financed property.

Section 514(b)(1)(A) 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 1.513-1(a) of the Income Tax Regulations ("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 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.

Section 1.514(b)-1(b)(1)(ii) of the regulations provides that if substantially all of any property is used in a manner described in subdivision (i) of this subparagraph, such property shall not be treated as "debt-financed property." In general, the preceding sentence shall apply if 85 percent or more of the use of such property is devoted to the organization's exempt purpose.

Section 514(b)(1)(A) of the Code provides that if substantially all of the use of any property is substantially related to the exercise or performance of an organization's exempt purpose, such property is not treated as "debt-financed property." The extent to which property is used for a particular purpose is determined on the basis of all the facts and circumstances. In this instance, the Property is going to be used by Medical to operate a medical college and to provide graduate medical education, as well as research and clinical education, to enrolled students. The rental of the Property by Title Holding to Medical will be in furtherance of Title Holding's exempt purposes within the meaning of section 1.513-1(d)(2) of the regulations. Pursuant to section 511(c), Title Holding will be treated as having the charitable and educational purposes of the Foundation because Title Holding will distribute its profits to and file consolidated returns with Foundation. Such purposes will include the advancement of education or science, and the instruction or training of individuals for such purposes. The rental of the Property by Title Holding to Medical to provide graduate medical education, as well as research and clinical education, will be related to Title Holding's purposes, the advancement of education or science, and the instruction and training of individuals for such purposes, within the meaning of section 501(c)(3). Therefore, the Property, owned by Title Holding and subject to an acquisition indebtedness under section 514(c), is exempt from the term "debt-financed" property pursuant to section 514(b)(1)(A)(i), because all of the use of the Property is substantially related to the performance by the Foundation and Medical, both related entities, of their exempt purposes. Income from the rentals does not, therefore, result in UBTI under section 511.

Therefore we rule that:

1. The Property leased by Title Holding to Medical will not be "debt-financed property" within the meaning of section 514 of the Code; and

2. Title Holding will not have unrelated trade or business taxable income under section 514(a) of the Code as a result the transactions described above.

We have not been asked and express no opinion on whether payments received by Title Holding from Medical would be subject to tax by reason of section 512(b)(13) 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 the sections of the Code as noted above. 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