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

Date: JUL 12 1999

Employee Identification Number:

Significant Index Numbers:

512.10-00
513.00-00
514.01-00
514.06-00

Contact Person:

Contact Number:

Refer Reply to:
OP:E:EO:T:4

Employer Identification Number:
Key District:

Legend:

M =
N =
O =
P =
Q =

x =

Dear Sir or Madam:

This is in response to your letter dated November 24, 1998 concerning whether the following transaction jeopardizes your exemption under section 501(c)(3) of the Internal Revenue Code and generates unrelated business income taxable within the meaning of sections 511-514 of the Code.

Facts:

M is a nonprofit corporation formed under the laws of the State of N in 1988. M is exempt from federal income tax under section 501(c)(3) and is a publically supported organization under sections 170(b)(1)(A)(vi) and 509(a)(1) of the Code.

M was created by O, an unincorporated association which is exempt under section 501(c)(10) of the Code pursuant to the group exemption ruling issued to P in 1971. M is controlled by O. Neither M nor O have debt.

In 1997, O purchased land to build a facility for itself and for M to carry out its charitable and educational function. To date, no construction has begun.

M's principal activity is the operation of Q. It tests children for learning disabilities, analyzes the test results, recommends remedial training, interacts with school districts to provide educational support for its patients and refers children to other organizations and professionals for treatment. In some cases, M also pays for treatment that it cannot provide. It also conducts educational classes for parents, teachers, schools, churches and others working with learning disabled children and

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In addition, M is a passive participant in O's college scholarship program. Although M awards the scholarships, O selects the recipients and provides the funds to pay the scholarships. M does not solicit for donations for the scholarships, nor does it use any of its contributions from the public to make these payments.

O plans to transfer land and approximately $1x in cash to M. M will construct a building in two phases. Phase I will consist of about 9,500 square feet, of which about 6,300 square feet will be used for M's charitable and educational purposes. About 3,200 square feet will be leased to O for its use as office and administrative spaces. The space will be leased at rents determined to be current market rental rates, by an independent professional appraisal.

Phase II will result in the construction by M of about 16,000 square feet of space to be leased to O for its fraternal activities. O may also sublease some of the space for use by the public for wedding receptions, art shows, musical and drama performances. There will also be occasional use of the facility by other related organizations for a fee. All rent and fees charged to regular tenants, O, P, and members of the public making use of the facilities will be at fair rental value for the property, as recommended by an independent expert in the real estate appraisal business. Services provided in connection with the rental of facilities will be only the usual and customary services including janitorial services. The rent and fees collected by M are expected to exceed the operating expenses of the facility. M will use the resulting excess revenue to support its charitable activities.

Analysis:

Section 501(c)(3) of the Internal Revenue Code provides for the exemption from federal income tax of organizations that are organized and operated "exclusively" for charitable, religious, educational, or other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in its generally accepted legal sense. The term includes the promotion of education. Providing testing for learning disabilities in children and conducting classes for teachers and parents about learning disabilities serve an educational purpose.

Section 509(a)(1) of the Code refers to organizations described in sections 170(b)(1)(A)(i) through (vi). Section 170(b)(1)(A)(vi) describes an organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a) from a governmental unit referred to in subsection (c)(1), or from direct or indirect contributions from the general public.

Section 1.170A-9(e)(2) of the regulations provides that an organization will be treated as a "publicly supported" organization if the total amount of support which the organization "normally' receives from governmental units referred to in section 170(c)(1), from contributions made directly or indirectly by the general public, or from a combination of these sources, equals at least 33 1/3 percent of the total support 'normally' received by the organization.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected

with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(3) of the Code excludes all rents from real property (unless more than 50 percent of the total rent is attributable to personal property on the premises) from the computation of unrelated business taxable income.

Section 1.512(b)-1(c)(5) of the regulations provides that payments for the use or occupancy of rooms and other space where usual or customary services are also rendered are generally treated as rent from real property.

Section 513 (a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 514(a)(1) of the Code provides for the taxation of debt-financed property which is used in an unrelated trade or business. Section 514(b)(1) defines the term "debt-financed property" to mean any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year. Section 514(c)(10(A) defines the term "acquisition indebtedness" to mean, with respect to any debt-financed property, the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property.

Rationale:

The financial information that M has submitted through 1998 indicates that M has met the one-third 'good support' test set forth in section 1.170A-9(e)(2) of the regulations in all the years of its existence. With respect to the construction project, O will transfer land that is debt free to M. O will also transfer funds to M to construct a building. M does not expect to incur any debt for construction of the building. M will provide only services usually and customarily provided with rental of space in the building. Accordingly, the building will not be debt-financed property within the meaning of section 514(b)(1) of the Code and the rental income derived therefrom is excludable from the unrelated business tax under section 512(b)(3) of the Code.

Conclusion:

Based on the foregoing, we rule as follows:

1. M will continue to be an organization exempt from tax, as defined in section 501(c)(3) of the Code and shall be classified as an organization other than a private foundation in accordance with sections 509(a) (1) and 170(b)(1)(A)(vi) as long as M continues to meet the applicable public support test..

2. Contributions from members of O, other lodges affiliated with P as well as contributions from other members of the general public for the purpose of the building fund previously described will be deductible by donors.

3. Rental income received by M from O and other organizations, entities and individuals shall not constitute unrelated business taxable income within the meaning of sections 512(b)(5) and 513(a) of the Code and 1.513-1(a) of the regulations on the assumption that no services will be provided other than those usually and customarily rendered in connection with the rental of space for occupancy only.

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

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

The rulings in this letter only apply the specifically indicated sections of the Code and regulations to the facts that you have represented. In this letter we do not rule on the applicability of any other sections of the Code and regulations to your case.

We are sending a copy of this ruling to your Key District Director for exempt organization matters. Because this letter could help resolve any questions about foundation status, it should be kept with your permanent records.

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
Chief, Exempt Organizations
Technical Branch 4

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