



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Employer Identification Number:

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Dear :

This is in response to X's request dated May 28, 2004, for a ruling under section 512 of the Internal Revenue Code regarding the federal tax consequences associated with the transactions described below.

X is exempt from federal income tax under section 501(c)(3) of the Code, and is classified as an organization described in sections 509(a)(1) and 170(b)(1)(A)(ii). X is subject to the tax imposed by section 511(a)(1) on any unrelated business income X may have.

X was founded in 1917 and incorporated under the laws of the State of M in 1920. It is a nonprofit, nonsectarian educational organization providing care, treatment, and education to at-risk, wayward, troubled, or disadvantaged children.

In 1988, X's Board of Trustees adopted a strategic plan that emphasized national program expansion. X has diverse operations in several states. In 2003, X cared for approximately 40,000 children through its major programs. X's operating expenditures have doubled from 1991

to 2003, demonstrating a continuing need to find funding sources for expanding program needs.

The property being considered for sale consists of approximately x acres adjacent to X's home campus. X acquired this farm property, totaling y acres, at a total cost of z dollars from 1938-1949. Several of the acres were taken by eminent domain, and additional acres were taken by the state for road construction, leaving x acres.

The property was originally acquired to help X maintain its self-sufficiency by growing feed grain for cattle used to provide milk and meat to feed the youth in its program. The property has been used for agriculture continuously from acquisition to the present day.

In 1975, X moved away from dormitory living arrangements with institutional group meals to a family-style, neighborhood environment. At the same time, health regulations from the M Department of Social Services and other regulating agencies began to preclude the possibility of continuing the old pattern of growing food for self-sufficiency. The last of the cattle was sold in 1991. Additionally, in 1988, X's Board of Trustees adopted a plan emphasizing national program expansion, eliminated the need for the property for home campus expansion.

Recognizing that this property was no longer needed for the direct sustenance of the children under X's care, the Board of Trustees declared the property surplus. X's management was authorized to dispose of the property and to dedicate the proceeds to additional funding for the care of children.

In February 2004, a prominent real estate consultant was retained to review and analyze the market for possible disposal of the property in question. The consultant reported that:

1. The property is suitable for an array of income producing land uses, including office park, single-family residence, multifamily residence and medical.
2. The range of value of the tract it stands is approximately xx dollars to yy dollars; thus, it is unlikely that any one buyer would be financially able to acquire the entire x acre tract.
3. The conceptual land use plan developed by consulting engineers indicates disposition of a series of up to nine tracts to different developers over a reasonable period would allow X to receive maximum value, consistent with its fiduciary duty, for the property (up to yy dollars) while controlling the pace and type of development. It is estimated that engineering, legal, environmental testing, survey, and consulting fees related to the implementation of the concept would not exceed zz dollars. The developers of each tract would be responsible for construction and installation of all site improvements, including roadways and utility hookups.
4. No improvements will be required to make the property more attractive for sale. Gas, electric, sewer, and water utilities already abut the site. Demolition of farm buildings and grading would be the responsibility of the purchaser(s).
5. A passive, patient marketing approach would be utilized. A prospectus should be

prepared for distribution to interested parties. The property would not be listed for sale with real estate brokers. However, finders' fees at negotiated rates may be paid for transactions consistent with the limited development concept.

In 1992, a favorable ruling from the Service, Private Ruling 9247038, was issued to X in connection with the sale of another agricultural tract adjacent to the home campus. X states that the sale of the individual tracts for that property, whose estimated completion time was to be within 5-10 years, was accomplished within that time frame.

X has requested the following rulings in connection with this series of transactions:

1. The proposed sale of surplus real estate in the manner described does not constitute unrelated trade or business regularly carried on by X within the meaning of section 513 of the Code.
2. The surplus real estate is not property held primarily for sale to customers in the ordinary course of any trade or business regularly carried on by X within the meaning of section 512(b)(5)(B) of the Code.
3. The gain to be realized by X on the sale of the surplus real estate will not be unrelated business taxable income and, therefore, will not be subject to the unrelated business income tax provided by section 511 of the Code.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for religious, charitable, scientific, or educational purposes so long as no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

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) 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 stock in trade or other property of a kind which would properly be includable in inventory if on hand at the close of the taxable year, or 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.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

Section 1.513-1(a) of the regulations provides, in part, that unless one of the specific exceptions of section 512 or 513 of the Code applies, the gross income of an exempt organization subject to the section 511 tax is includible 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 states that the term "trade or business" has the same meaning as in section 162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c) of the regulations provides, in part, that a business activity will be deemed to be regularly carried on if it manifests a frequency and continuity, and is pursued in a manner generally similar to commercial activities of non-exempt organizations.

Section 1.513-1(d)(2) of the regulations states that a trade or business is related to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it 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 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 from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of goods or the performance of services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

In Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. She listed the land for sale with a licensed real estate broker whom she authorized to subdivide the land and develop it for sale. The broker had the land platted and laid out into subdivisions with several lots. Although no improvements were made on the lots themselves, streets were cleared, graded, and shelled; storm sewers were put in at street intersections; gas and electric lines were constructed; and a water well was dug. Each year 20 to 30 lots were sold. In holding that the taxpayer, with the broker as her

agent, was holding lots for sale to customers in the regular course of business, the Court stated that the sole question was whether the taxpayer was in the business of subdividing real estate. The fact that she did not buy additional land did not prevent the sales activities from being a business as she had enough land for a business without buying more.

In Mauldin v. Commissioner, 195 F.2d 714 (10th Cir. 1952), the Court explained that there is no fixed formula or rule of thumb for determining whether property sold by a taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business. Each case must rest upon its own facts. The Court identified a number of helpful factors to point the way, among which are the purposes for which the property was acquired, whether for sale or investment; and, continuity and frequency of sales as opposed to isolated transactions. Also to be considered are any other facts tending to indicate that the sales or transactions are in furtherance of an occupation of the taxpayer, recognizing however, that one actively engaged in the business of real estate may discontinue the business and simply sell off the remnants of his holdings without further engaging in the business. The Court reasoned that while the purpose for which the property was acquired is of some weight, the ultimate question is the purpose for which it was held.

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. The Court interpreted the word "primarily" to mean "of first importance" or "principally."

Adam v. Commissioner, 60 T.C. 996 (1973), provides several guidelines to be used to determine whether a taxpayer engaged in a land transaction in furtherance of a trade or business. The factors to be considered include (1) the purpose for which the asset was acquired; (2) the frequency, continuity, and size of the sales; (3) the activities of the seller in the improvement and disposition of the property; (4) the extent of the improvements made of the property; (5) the proximity of the sale to the purchase of the land; and (6) the purpose for which the property was held during the taxable year are all useful in making this determination. No one factor is controlling but all are relevant facts to consider in what is basically a facts and circumstances test.

In Parklane Residential School, Inc. v. Commissioner, T.C.M. 1983-139, an organization exempt under section 501(c)(3) of the Code had as its exempt function the operation of a school for mentally disabled children. The school entered into 22 simultaneous transactions involving the purchase and sale at a profit of real properties over two years. The Court held that this activity was not substantially related to the exercise or performance of petitioner's exempt function (i.e., the operation of a school for mentally retarded children). Even though the profits were ultimately used to further petitioner's exempt function, the source of the funds was, in essence, an unrelated business. The Tax Court stated that the fact that the petitioner entered into 22 transactions belied any suggestion that the business was not regularly carried on.

In Houston Endowment v. United States, 606 F.2d 77 (5th Cir. 1979), the criteria used by the Court in determining whether property sold by a taxpayer was held primarily for investment or for sale to customers in the ordinary course of business" are: (1) the substantiality and

frequency of sales, (2) improvements, (3) solicitation and advertisement, and (4) broker's activities. According to the Court, the frequency and substantiality of the taxpayer's land sales are the most important criteria. The Court goes on to state that "although a taxpayer may have acquired property without intending to enter the real estate business, what was once an investment or what may start out as a liquidation of an investment, may become something else. [W]here sales are continuous, the nature and purpose of a taxpayer's acquisition of property is significant only where sales activity results from unanticipated, externally introduced factors which make impossible the continued pre-existing use of the realty. Original investment intent is pertinent, for example, when a taxpayer is coerced to sell its property by acts of God, new and unfavorable zoning regulations or other uncontrollable forces." An additional criterion noted in Houston Endowment is the presence of improvements on the land at issue. The plaintiff's predecessor in interest constructed roads, water lines, sewers, and railroad tracks to enhance the attractiveness of the land to purchasers and to increase the return on the sale of the property. While this criterion is of lesser importance than the substantiality and frequency of sales, it also indicates that the land was held for sale in the ordinary course of business. See also, Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976).

Rev. Rul. 59-91, 1959-1 C.B. 15, describes a corporation that sold a portion of its property that had been held as an investment. The property was subdivided into residential lots, graded, the streets surfaced, and the required drainage and utilities were installed. In holding that the gains realized from the sales of the lots constituted ordinary income, the ruling implies that the sizeable improvements made in order to facilitate the sales led to the conclusion that the property was held primarily for sale to customers. The revenue ruling cites Mauldin v. Commissioner, supra, where the facts indicated that the taxpayer had subdivided land and made improvements to it in order to facilitate sales and to and derive the maximum proceeds from the disposition of the property. While the property was originally purchased for purposes other than sale in the ordinary course of trade or business (cattle raising), after such division and improvement, the lots were considered to be held by the taxpayer primarily for sale to customers in the ordinary course of trade or business.

Factors which 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.

See Adam, supra. No one factor is controlling but all are relevant facts to consider in what

is basically a facts and circumstances test. See also Houston Endowment, supra; Biedenharn Realty Co., supra.

X proposes to sell land that it acquired for farming purposes to enhance its self-sufficiency and which it has held for a significant period of time. This is completely contrary to the short turn around period experienced by a typical buyer and seller of real property. Certain regulatory changes have occurred which have compelled X to discontinue its farming practices on the property. Although the land is adjacent to X's home campus, an emphasis on national programs negates the property's use for home campus expansion. The increased emphasis on national programs has also increased X's expenses significantly. Based upon the fact that the property is presently surplus land, X has determined that it is in its best interest to sell the land in order to fund its exempt activities. The facts surrounding X's acquisition and sale of the property can be distinguished from those in Parklane, supra, where properties were purchased and sold at a profit over a short period of time in order to finance an exempt function that was not substantially related to the transactions.

X will not advertise the availability of the property for sale through real estate brokers, but will adopt a passive marketing approach whereby a prospectus will be prepared for distribution to interested parties. No more than nine sales will occur over a reasonable period of time with the frequency and size of the sales dictated by the perception of the consultant so as to achieve maximum value consistent with X's fiduciary duties. No improvements are contemplated to enhance sale of the property. Buyers of the property would construct all site improvements, including roads and utilities, at their expense. X will not plat the property for specific lots. The platting of lots and subdivision within the tracts will be the responsibility of the buyer. Applying the facts and circumstances test and the primary purpose test of Malat, supra, we have concluded that this transaction does not involve property held primarily for sale to customers in the ordinary course of business. Nor does the proposed sale of the surplus real estate under these circumstances and in the proposed manner constitute an unrelated trade or business within the meaning of section 513 of the Code. Therefore, income from the sale of this property is excluded from the computation of unrelated business taxable income by reason of section 512(b)(5).

Accordingly, based upon the information furnished, we rule as follows:

1. The proposed sale of surplus real estate in the manner described does not constitute unrelated trade or business regularly carried on by X within the meaning of section 513 of the Code.
2. The surplus real estate is not property held primarily for sale to customers in the ordinary course of any trade or business regularly carried on by X within the meaning of section 512(b)(5)(B) of the Code.
3. The gain to be realized by X on the sale of the surplus real estate will not be unrelated business taxable income and, therefore, will not be subject to the unrelated business income tax provided by section 511 of the Code.

This ruling applies the applicability of sections 511 through 513 to the facts represented above. We express no opinion as to the tax consequences of the transactions under any other provisions of the Code.

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

Because this letter could help resolve any future questions about tax consequences of X's activities, X should keep a copy of this ruling in its 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,

Joseph Chasin
Manager, Exempt Organizations
Technical Group 2