



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Date: 06/29/05

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

M =

N =

O =

P =

Dear :

This letter is in reply to the letter from the authorized representative of M dated September 30, 2004, in which M requested certain rulings with respect to the treatment of income derived from debt-financed property under section 514 of the Internal Revenue Code.

M is a continuing care retirement community recognized by the Internal Revenue Service as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code. M has also been determined not to be a private foundation because it is described in sections 509(a)(1) and 170(b)(1)(A)(vi).

As a continuing care retirement community, M provides long-term care, medical and custodial services, and housing. M states that it has a physical campus consisting of facilities designed to accommodate the resident needs of a number of adults in what are several levels of residence accommodation and care: independent living cottages and apartments, assisted living facilities, and a fully Medicare-certified licensed, skilled nursing facility. In addition M has special facilities for memory-impaired residents.

N is organized as a Limited Liability Company under the laws of O, and is wholly owned by M. M states that N has neither elected treatment as a corporation nor has it applied for tax exemption on its own.

M states that it owns excess land on its campus that is located adjacent to its main facilities. M has leased this land to N on an annual basis under the terms of a written lease. N has built a specialized medical office building on the land. N intends to encumber the building with mortgage debt at some time during or after the completion of construction. N will lease the entire building on a net lease basis to P under a written lease agreement. P is a regional full-service not-for-profit hospital, recognized as exempt under section 501(c)(3) of the Code, with its main hospital facility located a few miles away from M.

M states that P intends to use the leased building as an outpatient medical clinic to serve the residents of M as well as the surrounding community. P also intends to sublease portions of the building to independent medical-related tenants such as certain physician practice groups which have an economic interest in leasing space from the hospital at the clinic site due to the proximity of the location of the building to the large population of residents of M and the proximity of the building to serve local residents of the county who are not inclined to travel to the P's main facility to seek medical services due to the distance.

M has requested rulings that:

(1) N, as a wholly owned company of M, is a disregarded entity for federal income tax purposes, and its operations are to be encompassed with the existing tax exempt status of M.

(2) The building owned by M, through its 100% ownership of N, is not subject to the debt-financed property rules under section 514(b)(1) of the Code as the building's use meets the exception outlined in section 514(b)(1).

Section 501(c)(3) of the Code provides for exemption from federal income tax of organizations organized and operated exclusively for charitable, scientific, or educational purposes provided 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 section 501(c)(3) of the Code in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions.

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

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 certain allowable deductions and modifications.

Section 513(a) of the Code defines the term "unrelated trade or business" 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 the function constituting the basis of its exemption.

Section 1.513-1(d)(2) of the regulations provides that 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; and it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that 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.

Section 514(a)(1) of the Code provides that a portion of the income derived from, or on account of, each debt-financed property shall be included as an item of gross income derived from unrelated trade or business.

Section 514(b) of the Code defines "debt-financed property" to mean, with certain exceptions, 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(b)(1)(A)(i) 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, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.514(b)-1(c)(1) of the regulations provides that property is not debt-financed property if it is real property subject to a lease to a medical clinic, and the lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by the lessor of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 of the Code.

Announcement 99-102, 1999-2 C.B. 545, discussing final regulations under section 7701 of the Code, establishes that a limited liability company wholly owned by a single

organization exempt under section 501(a) may be disregarded as an entity separate from its owner. When an entity is disregarded as separate from its owner, its operations are treated as a branch or division of its owner. Therefore, an owner that is exempt under section 501(a) must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return.

The facts in this ruling request, as set forth above, show that N is wholly owned and operated by M. N has not elected treatment as a corporation and has not applied for exemption from federal income tax. M so controls the affairs of N that N is merely an instrumentality of M, and may be disregarded as an entity separate from M.

M's exempt purposes are to provide long-term care and housing to senior citizen residents in an environment that is self-contained, and which has graduated levels of service, including medical and custodial services, to meet the needs of the aging population who reside there. M also has a fully Medicare-certified licensed, skilled nursing facility in the retirement community. The mission of M is enhanced by allowing onsite medical facilities to be integrated into the retirement community through the construction of a medical clinic operated by a local hospital. For this reason, the property will be used for purposes that are substantially related to M's performance of its charitable purpose. Therefore, section 514(b)(1)(A)(i) of the Code and section 1.514(b)-1(c)(1) of the regulations are applicable to the use of this property.

Accordingly, based on the facts and circumstances, as stated above, we rule that:

(1) N, as a wholly owned company of M, is considered to be a disregarded entity for federal income tax purposes, and its operations are encompassed with the existing tax exempt status of M.

(2) The building owned by M, through its 100% ownership of N, is not subject to the debt-financed property rules under section 514 of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any such change should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. A copy of this ruling is being forwarded to the Ohio TE/GE Customer Service office.

Except as we have specifically ruled herein, we express no opinion as to the consequences of these transactions under the cited provisions or under any other provisions of the Code.

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.

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 yours,

Jane Baniewicz
Manager, Exempt Organizations
Technical Group 2