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March 18, 2022

Legend

Taxpayer =
Date =
Fire Pit =
Meeting Circle =
Fellowship Area =

Dear :

This letter responds to a letter dated September 27, 2021, and subsequent correspondence requesting a ruling that certain acquired land will not be treated as debt-financed property under section 514(b) of the Internal Revenue Code¹ (Code) for 15 years from date of acquisition because the land qualifies for the neighborhood land use exception set forth under section 514(b)(3).

Facts

Taxpayer is a tax-exempt organization recognized as described in section 501(c)(3) and classified as a church under section 170(b)(1)(A)(i). On Date, Taxpayer purchased three smaller, contiguous residential parcels of land (Parcels 1, 2, and 3) adjacent to its existing church property for the purpose of expanding the church and grounds. At the time of purchase, residential structures existed on each of the three parcels. In order to purchase the parcels, Taxpayer obtained a 20-year mortgage which was collateralized by the three properties and the church's existing sanctuary property. Taxpayer has stated that the structures on the three newly acquired properties must be demolished to complete the projects needed to further the church's exempt purpose.

¹ The Internal Revenue Code of 1986, as amended, to which all subsequent "section" references are made unless otherwise indicated.

Not long after acquiring the parcels, Taxpayer determined that expanding the sanctuary was not feasible within the near term. Accordingly, it was decided that construction of a new indoor/outdoor building, referred to as the Pavilion and described more fully below, would provide adequate expansion to satisfy the immediate need for space. The Pavilion will occupy land on Parcels 2 and 3. In addition, Taxpayer plans to construct an additional parking lot on the remaining portion of Parcel 3. Taxpayer has begun using a portion of Parcel 1 and all of Parcel 2 as outdoor meditation and gathering space in furtherance of Taxpayer's religious purposes. This includes a recently constructed Fellowship Area, a Fire Pit, and a Meeting Circle. Taxpayer follows certain principles, one of which encompasses respect for humanity, nature, and the environment. Taxpayer represents that using land more toward green spaces than hardscapes supports one of its primary principles and is therefore consistent with its exempt purposes.

During the year following the purchase of the parcels, Taxpayer donated the house located on Parcel 2 to a fire department to use in a fire training exercise and the house was burned to the ground. The Fellowship Area was established in its place to serve as an outdoor gathering space for children's camps, open air classrooms, a meditation garden, and other activities. The Fellowship Area development included creating raised beds to establish a border for the space, installation of lumber and cement to support shade sails for outdoor seating, and installation of a utility shed, including site preparation and installation of a gravel foundation.

As of the date of the ruling request, the houses on Parcels 1 and 3 were leased out as rental properties. Taxpayer has issued a notification of the termination of tenant's lease of the house on Parcel 1, which will be effective this year.

Subsequent to the development of The Fellowship Area on Parcel 2, Taxpayer's need for space was further exacerbated by the COVID-19 pandemic. Taxpayer's original lot consisted almost entirely of a single building housing the sanctuary and a parking lot with very little outdoor meeting space. Consequently, Taxpayer focused on improving the newly acquired parcels to provide more outdoor gathering space. Taxpayer installed a Fire Pit on Parcel 1 to facilitate adult and supervised children's gatherings. Two trees were cut into sections to use as seating and the Taxpayer worked with a conservation organization to assist with selecting and planting plant species to stabilize the creek banks at the border of the property and to reduce erosion. Taxpayer also created a Meeting Circle, which is located on the original property and a portion of Parcel 1.

Taxpayer is currently using the yard of Parcel 1 for various activities in furtherance of its exempt purposes, including Sunday morning classes in the spring and fall, a summer church camp, a monthly graphic novel book club to promote resiliency for at-risk teens, and monthly intergenerational events, such as pumpkin painting and carol singing. In addition, several adult groups use the Meeting Circle for their monthly meetings, including a conversation group, a church care team, and a men's group. Taxpayer also utilizes the outdoor space for various children's religious exploration activities, which

consist of moral, ethical, and religious instruction using a curriculum designed by religious professionals and taught by or under the supervision of Taxpayer's Director of Children's Religious Exploration. Children enrolled in the programming do service activities, social justice activities, and activities designed to help them become more caring and resilient. These activities are essential to the work of the congregation in fulfilling its mission.

Shortly after submitting its private letter ruling request, Taxpayer filed an application with its city for a zoning amendment to combine the original and newly acquired church properties into an institutional campus, a zoning designation available only to churches and schools in Taxpayer's county. If granted, this zoning amendment would allow Taxpayer to engage in improvement projects which span more than one parcel without having to satisfy interior setback requirements. The requested amendment has been approved by the city's planning board and will soon be presented for final approval by the city council. Also last year, Taxpayer hired an engineering company to prepare a report exploring and analyzing the parcels for the proposed development of the new property. Taxpayer's Board of Trustees subsequently approved development drawings and a proposed timeline for development activities. Taxpayer also consulted with at least one additional contractor who has visited the site and provided an estimate regarding demolition costs.

Under the current plan, once the house on Parcel 1 is vacated by the current tenant, Taxpayer will begin to use the house for the children's religious exploration activities described above. Within the next four years, Taxpayer will terminate the lease of the house located on Parcel 3 and have the house demolished. Taxpayer will then begin construction of an indoor/outdoor structure which will be located on Parcels 2 and 3, called the Pavilion. The Pavilion will have two sections. One end will be a closed, heated system with water and electricity. The other end will be an open, covered, weather-protected space. The open portion of the Pavilion will be larger than the largest space in its sanctuary. The Pavilion will have its own parking lot, including handicapped parking spaces, because this building will be constructed at a distance from the church's current parking lot. Upon completion of the Pavilion, the children's religious exploration activities will be relocated from the Parcel 1 temporary site to the Pavilion. In addition to the children's religious exploration activities, the Pavilion will be used for other church gatherings, which may include weddings and other life transition events, learning experiences, and storage for the church. Within the next seven years, Taxpayer will have the structure on Parcel 1 demolished. Taxpayer will make improvements to Parcel 1 to remediate erosion and have the parcel landscaped for use for outdoor gatherings. Taxpayer plans to incorporate native plants, boardwalks to keep individuals from further eroding the creek areas via foot traffic, and seating which will provide a welcoming grounds environment where church members and visitors may experience beauty, serenity, worship, or quiet contemplation in surroundings created with respect for the integrity of the Earth and its local ecosystems.

The new church facilities, including the Pavilion, Pavilion parking area, and other outdoor gathering spaces, will be completed and placed into service before the expiration of the 15-year period commencing on the date of acquisition of these properties.

Taxpayer has started a capital drive to retire the debt incurred to acquire the land and intends to conduct additional capital drives over the next several years to fund grounds work, outdoor gathering spaces, and construction of the Pavilion.

Over the past five years, the acquired buildings have been used in furtherance of exempt purposes, including as a parsonage and as a home for individuals in addiction recovery, and as non-exempt purpose rental properties. Throughout the years since the properties were purchased, the Board of Trustees has periodically reaffirmed the church's original plan to demolish the buildings located on the purchased parcels and use the land in furtherance of the church's exempt purposes. As the Board of Trustee members change, the intention is reaffirmed with the new members. For each of the past three years, the Board meeting minutes have included information demonstrating the Board's continued intent to use the land in furtherance of the church's exempt purposes. Further, Taxpayer has represented that any additional development and use in the future of Parcels 1, 2, and 3 will be solely for exempt purposes.

Ruling Requested

Taxpayer has requested a ruling that the acquired land will not be treated as debt-financed property under section 514(b) of the Code for 15 years from date of acquisition because the land qualifies for the neighborhood land use exception set forth under section 514(b)(3).

Law

Section 512(a)(1) defines the term "unrelated business income" to include the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less deductions allowed which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b)(3) generally exempts from unrelated business taxable income rents from real property.

Sections 512(b)(4) and 514 generally impose income tax, notwithstanding the exception for rents under section 512(b)(3), on unrelated business taxable income from debt-financed property.

Section 514(a)(1) 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

an unrelated trade or business.

Section 514(b)(1) 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)(3)(A) provides a special rule for neighborhood land. If an organization acquires real property for the principal purpose of using the land (commencing within 10 years of the time of acquisition) in the manner described in section 514(b)(1)(A) and at the time of acquisition the property is in the neighborhood of other property owned by the organization which is used in such manner, the real property acquired for such future use shall not be treated as debt-financed so long as the organization does not abandon its intent to so use the land within the 10-year period. The preceding sentence shall not apply for any period after the expiration of the 10-year period, and shall apply after the first 5 years of the 10-year period only if the organization establishes to the satisfaction of the Secretary that it is reasonably certain that the land will be used in the described manner before the expiration of the 10-year period.

Section 514(b)(3)(C) provides that section 514(b)(3)(A):

- (i) shall apply with respect to any structure on the land when acquired by the organization, or to the land occupied by the structure, only if (and so long as) the intended future use of the land for an exempt purpose requires that the structure be demolished or removed in order to use the land in such manner;
- (ii) shall not apply to structures erected on the land after the acquisition of the land; and
- (iii) shall not apply to property subject to a lease which is a business lease (as defined in this section immediately before the enactment of the Tax Reform Act of 1976).

Section 514(b)(3)(E) extends, in the case of a church, the special rule for neighborhood land from a 10-year to a 15-year period. In addition, churches are eligible for the special rule even if the acquired land does not meet the neighborhood test.

Section 514(c)(1)(A) defines the term “acquisition indebtedness” to include, with respect to any debt-financed property, the unpaid amount of indebtedness incurred in acquiring or improving the property.

Treas. Reg. § 1.514(b)-1(d)(1)(iii) provides that in order to satisfy the Commissioner that future use of the acquired land in furtherance of the organization’s exempt purpose before the expiration of the relevant period is reasonably certain, the organization does not necessarily have to show binding contracts. However, it must at least have a definite plan detailing a specific improvement and a completion date, and some affirmative

action toward the fulfillment of such a plan. This information shall be forwarded to the Commissioner of Internal Revenue, Washington, D.C. 20224, for a ruling at least 90 days before the end of the fifth year after acquisition of the land.

Treas. Reg. § 1.514(b)-1(d)(3)(i)(a) provides that the neighborhood land rule will apply to land with a structure on it when acquired, or to the land occupied by the structure, only so long as the intended future use of the land requires that the structure be demolished or removed in order to use the land in furtherance of exempt purposes.

Treas. Reg. § 1.514(b)-1(d)(3)(i)(b) illustrates the above paragraph by the following examples:

Example 1.

An exempt university acquires a contiguous tract of land on which there is an apartment building. The university intends to demolish the apartment building and build classrooms and does not abandon this intent during the first 4 years after acquisition. In the fifth year after acquisition it abandons the intent to demolish and sells the apartment building. Under these circumstances, such property is not debt-financed property for the first 4 years after acquisition even though there was no eventual demolition or use made of such land in furtherance of the university's exempt purpose. However, such property is debt-financed property as of the time in the fifth year that the intent to demolish the building is abandoned and any gain on the sale of property is subject to section 514.

Example 2.

Assume the facts as stated in Example 1 except that the university did not abandon its intent to demolish the existing building and construct a classroom building until the eighth year after acquisition when it sells the property. Assume further that the university did not receive a favorable ruling in accordance with Treas. Reg. § 1.514(b)-1(d)(1)(iii). Under these circumstances, the building is debt-financed property for the sixth, seventh, and eighth years. It is not, however, treated as debt-financed property for the first 5 years after acquisition.

Example 3.

Assume the facts as stated in Example 2 except that the university received a favorable ruling in accordance with Treas. Reg. § 1.514(b)-1(d)(1)(iii). Under these circumstances, the building is not debt-financed property for the first 7 years after acquisition. It only becomes debt-financed property as of the time in the eighth year when the university abandoned its intent to demolish the existing structure.

Treas. Reg. § 1.514(b)-1(e)(1) provides that if a church or association or convention of churches acquires real property, for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 15 years of the time of acquisition, such property shall not be treated as debt-financed property so long as the organization does not abandon its intent to use the land in such a manner within the 15-year period.

Treas. Reg. § 1.514(b)-1(e)(2) provides that Treas. Reg. § 1.514(b)-1(e) shall not apply to any property after the expiration of the 15-year period. Further, Treas. Reg. § 1.514(b)-1(e) shall apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the Commissioner that use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 15-year period is reasonably certain. For purposes of the preceding sentence, the rules contained in Treas. Reg. § 1.514(b)-1(d)(1)(iii) with respect to satisfying the Commissioner that the exempt organization intends to use the land within the prescribed time in furtherance of its exempt purpose shall apply.

ANALYSIS

Taxpayer is exempt from federal income tax under section 501(a), described in section 501(c)(3), and classified as a church under section 170(b)(1)(A)(i). On Date, Taxpayer purchased three parcels of land, with structures existing on each, in order to expand the church and grounds. Taxpayer acquired these properties subject to acquisition indebtedness, as defined in section 514(c)(1)(A), and has derived rents from the properties.

Section 512(b)(3) generally exempts from unrelated business taxable income rents from real property. Notwithstanding this modification for certain rents under section 512(b)(3), any income derived from rents from debt-financed property, as defined by section 514(b)(1), is generally treated as unrelated business taxable income under section 512(a)(1). See section 512(b)(4). Under section 514(b)(3), however, when real property is acquired by a tax-exempt organization for the principal purpose of using it in the exercise or performance of its exempt purpose within 10 years of the date of acquisition, and the acquired property is in the neighborhood of other property owned by the organization and used for an exempt purpose, the real property will not be treated as debt-financed property so long as the organization does not abandon its intent to so use the land within the 10-year period. This exception is commonly referred to as the "neighborhood land rule." If the organization is a church or a convention or association of churches, section 512(b)(3)(E) provides that a 15 rather than 10-year period is applicable, and the acquired land does not need to meet the neighborhood test. Under the neighborhood land rule, any structure located on the land when acquired must be demolished or removed in preparation for exempt use of the land. See section 514(b)(3)(C). In order to qualify for use of the neighborhood land rule after the first 5 years of the 10 or 15-year period, section 514(b)(3)(A) provides that a taxpayer must request and receive a favorable ruling from the IRS.

As required by Treas. Reg. § 1.514(b)-1(d)(1)(iii), Taxpayer submitted its ruling request in a timely manner, at least 90 days prior to five years after the date of acquisition of the land at issue. Further, consistent with Treas. Reg. § 1.514(b)-1(d)(1)(iii) and (e)(2), Taxpayer has established that it has a definite plan detailing specific improvements and completion dates, and that it has taken affirmative action toward the fulfillment of its

plan, such that it is reasonably certain that the acquired land will be used in the exercise or performance of its exempt purpose within 15 years from Date.

Taxpayer purchased three parcels of land with the intent to use the land for its exempt purposes. Since its acquisition of the properties, Taxpayer has engaged in various planning and improvement activities which demonstrate that Taxpayer has not abandoned its initial intent for the use of the land. See Treas. Reg. § 1.514(b)-1(e)(1). Taxpayer's current plan anticipates that each existing structure will be demolished as required by section 514(b)(3)(C)(i) and Treas. Reg. § 1.514(b)-1(d)(3)(i) and construction of a new facility, parking, and grounds improvements will begin within the next four to seven years. If an organization abandons its intent to demolish existing structures and use the land in furtherance of exempt purposes, the land will be treated as debt-financed property as illustrated in the examples in Treas. Reg. § 1.514(b)-1(d)(3)(i)(b). Taxpayer has already demolished one of the three buildings and begun to use the property on which it was situated for the exempt purposes of the church, specifically as an outside gathering space for children's camps, open air classrooms, a meditation garden, and other activities. Taxpayer has also engaged an engineering company and consulted with at least one construction company regarding demolition of the remaining structures and the development of the properties. Taxpayer has started a capital drive to reduce outstanding debt and set target dates for future capital drives to support construction and grounds work. The Taxpayer-approved plan provides that the new expanded church facilities will be completed and placed into service before the expiration of the 15-year period commencing on the date of acquisition of these properties.

RULING

Based on the foregoing, and assuming the accuracy of the facts and representations submitted by Taxpayer, we rule that the acquired land will not be treated as debt-financed property under section 514(b) of the Code for 15 years from date of acquisition because the land qualifies for the neighborhood land use exception set forth under section 514(b)(3).

The ruling contained in this letter is based upon information and representations submitted by or on behalf of Taxpayer and accompanied by penalties of perjury statements executed by an individual with authority to bind Taxpayer and upon the understanding that there will be no material changes in the facts. While this office has not verified any of the material submitted in support of the ruling request, such materials are subject to verification on examination.

The Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes) will revoke or modify a letter ruling and apply the revocation retroactively if: (1) there has been a misstatement or omission of controlling facts; (2) the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or (3) the transaction involves a continuing action or

series of actions and the controlling facts change during the course of the transaction. See Rev. Proc. 2022-1, 2022-1 IRB 1, § 11.05.

This letter does not address the applicability of any section of the Code or Regulations to the facts submitted other than those sections specifically described. Further, except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Because it could help resolve questions regarding federal income tax status, this letter should be kept in the Taxpayer's permanent records.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) provides that it may not be used or cited by others 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,

Matthew Giuliano
Branch Chief, Exempt Organizations Branch 1
(Employee Benefits, Exempt Organizations, and
Employment Taxes)

cc: