



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200530029**
Release Date: 7/29/2005
234970

Date: 05/05/05

U.I.L. Numbers:
511.00-00
512.00-00
513.00-00

Employer Identification Number:

LEGEND:

A =

M =

X =

Y =

Z =

Dear :

This is in response to X's request dated May 26, 2004, for a ruling under section 512 of the Internal Revenue Code regarding the federal tax consequences associated with the transactions described below. The request was submitted by X's legal representative. Supplemental information was provided in a letter dated February 9, 2005.

X is a perpetual charitable trust subject to the laws of the state of M created by A pursuant to a Declaration of Trust. There have been two amendments to the Declaration of Trust. X is exempt from federal income tax as an organization described in section 501(c)(3) of the Code and is a private foundation under section 509 of the Code.

X has engaged in a broad range of charitable activities, ranging from providing land and facilities to another charitable organization (Y) for youth programs, to the funding of literacy and educational programs and facilities.

X's sole asset for several years was the original small contribution provided by A. In 1990, A created an M Land Trust (Land Trust) to hold title to three parcels of unimproved land owned by A (the 1990 Land). Beneficial interest under the Land Trust was assigned to X, and X became the sole beneficiary after the assignment. The purpose of the Land Trust was to hold title to the 1990 Land for X.

X represents that after A's death, X was unable to sell the property because of the virtual depression in real estate in M. In order to put the property to charitable use, X's trustees authorized the lease of the 1990 Land at nominal rent to Y or a similar charitable entity. The property was leased to Z, with the lease providing that as additional property was received by X from A's estate, it could be added or used as a replacement for the 1990 Land.

X merged with another charitable trust exempt under section 501(c)(3) of the Code that A had created, with X surviving the merger. As a result of the merger, X received the residue of A's estate including unimproved land, several acres of which adjoined the property previously leased to Z. Pursuant to amendments of the initial lease, X leased land to Z in 1997 (1997 Land), and added additional property in 2000 (2000 Land). X also received other properties from A's estate that were not leased to charitable entities or otherwise held for exempt purposes. X sold some of the properties to a 501(c)(3) organization to be used for affordable housing, made a grant of property to a 501(c)(3) organization as partial fulfillment of a grant, and liquidated other property whose proceeds have been invested to support X's charitable purposes. Most of the property sold consisted of unimproved real property. The properties were sold "as is" with X making no improvements other than routine property maintenance, cleaning and required remedial action on one property. The remainder of the property is unimproved land that is valuable, but generates expenses primarily in the form of real estate taxes and the costs of maintenance with no offsetting income.

It is the disposition of the 1997 Land and the 1990 Land (collectively, the "Land"), undeveloped property in M, that is the subject of the ruling request. Part of the Land that X presently holds is under contract, which may be assigned to a foundation for the benefit of specified section 501(c)(3) organizations as part of the fulfillment of a charitable grant. The remaining acreage consists of separate parcels that are generally contiguous to each other. X purchased a small parcel of land that was bordered on three sides by its property with the fourth side being a public highway giving access to the rest of the property.

Z has continuously used the land for exempt activities. X has actively participated in assuring that the land meets the need of Z, and has modified and improved the land

in various ways solely for Z's use. Since the inception of the original lease, X has made cash grants to Z with a commitment for future financial support.

The Land has been affected by the decisions of numerous federal, state and local officials beyond the control of X, including several actions by the county calling for a higher density on the land each time. In addition, state and local officials have given permission to a private developer for a project that has resulted in significant transportation improvements that have supported and encouraged large amounts of additional development in the area where the Land lies. In response to the local government's development plans which will impact the land's use, X requested and receiving a zoning change.

As a result of the changes and the booming real estate market, the property's assessed value has increased. Because of the real estate tax burden created by the rezoning and property tax assessment, X has been forced to liquidate some of its real estate holdings to maintain its ability to fund its charitable endeavors. X represents that it will be unable to find a single buyer for the entire property at fair market value upon reasonable terms because of the size of the land holdings. In addition, because of changes in the surrounding properties, an increased population, and decisions made by local, state and federal agencies, X believes that future use of the Land for the community will occur in a way unlike its current use by Z.

X's trustees determined that because of the long term development process and various contingencies and unknown factors, it would make its own analyses of the factors so that it could appropriately assess both the current value of the Land and the potential future value when the contingencies were met and the unknowns determined. To assist in this determination, X had a pro-forma development plan prepared for the Land and obtained detailed geological studies of the Land. Future engineering will consist of primarily supplemental studies as to the value of the Land, e.g., type and depth of rock substrata; updates of studies done during the rezoning for future traffic, utilities etc.; and, compliance with Federal and State environmental laws. The engineering would be consistent with governmental planning and regulation. X is not arranging for any final engineering such as site plans, subdivision into saleable house or office lots (as compared to large subdividable parcels), or designs for roads, utilities, etc.

X is required by the local government to dedicate portions of the Land to public use.

Other than a ten acre parcel that provides access to the property, a one acre parcel, and parcels to be created to be dedicated (given) to the public or qualifying public charities (i.e. park/a school site, a public safety site, and the location of a public transportation station), no parcel will be created for sale of less than twenty (20.0) acres. All such for sale parcels will be sold to developers who will be solely responsible for all design, engineering, subdivision into lots, infrastructure, construction, etc.

necessary to put the parcel into economically productive use. It is possible that some parcels may be conveyed by long-term ground lease. In such cases, the lessee will be responsible for the design, engineering, infrastructure, construction, etc.

Other than the parcels to be given to the public or given to public charities, X will be conveying (sale or long-term ground lease) no more than two (2) parcels per year. It is anticipated that the conveyances will take at least twenty (20) years to complete, primarily due to the timing of the expansion of the transportation system. X anticipates making sales of one parcel per year on the average.

X does not advertise the availability of the Land for sale through real estate brokers but will adopt a passive marketing approach. A prospectus will be prepared and will be made available to interested parties. Information from the development plan has been collated into a book that has been made available to the local government and potential purchasers. In order to assure that only interested purchasers would request the book, X has required any prospective purchaser to "contribute" to a local foundation.

X represents that it has never borrowed funds to acquire any of the land. X further represents that there have been no mortgages on the Land during the time X has held title, and the land is not debt-financed property within the meaning of section 514 of the Code.

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

1. X's procurement of detailed site engineering plans for the Land and division of the Land into parcels through the local government's required procedures will not cause the Land to be held primarily for the sale to customers in the ordinary course of a trade or business within the meaning of section 512(b)(5) of the Code.
2. Sale or long-term lease of the Land over time, in undeveloped parcels, for further improvement, subdivision, or development by others will not result in gain realized on the sale(s) being taxed as unrelated business taxable income under section 511 of the Code and should be excluded from the computation of unrelated business taxable income under section 512(b)(5) of the Code.

Section 501(c)(3) of the Internal Revenue 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) of the Code.

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 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 a 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 on 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, 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 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 belied any suggestion that the business was not regularly carried on.

In Houston Endowment v. Unites 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. 215, 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, 195 F.2d 741, 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 include:

- (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.

X proposes to sell land that it acquired by charitable gift or bequest from A, and which it has used for charitable purposes over the years. In support of these charitable purposes, X has made changes to the property that benefited Z's use of the property. Events beyond X's control have occurred that will make X's continued use of the property for these purposes impossible in the future. Also, because of the increased value of the vacant property and the lack of income to pay the accompanying increase in property taxes, X's trustee's have determined that it is in X's best interest to liquidate the undeveloped acreage and to use the proceeds for X's charitable programs.

While the property has increased in value, its size makes it impractical to offer the acreage for sale to a single buyer. X will obtain engineering plans and will divide the property for sale in accordance with government requirements, setting aside some property for use by the community. X's trustees believe that the sale of the property over a period of time will allow it to obtain the best price for the property, which will best serve X's interest in carrying out its charitable purposes. Because of certain contingencies and various unknown factors, X is unable to determine the time by which it will complete the sale of the property. However, it anticipates making no more than two sales per year over a twenty year period, with an average sale of one property per year.

Except for a small piece of land adjacent to the property, X has not purchased any land. X has liquidated properties that it acquired from A through the sale or grant of property to 501(c)(3) organizations or the sale of undeveloped land whose proceeds were used for investment in support of its programs. X will no longer be able to use the property for the charitable purposes it has supported over the years, and the property does not generate funds which could be used to maintain it. A portion of the land will be set aside for use by the community. In disposing of the Land, X will take steps to monitor the development plans by including provisions in the sales contracts setting forth high standards of quality to which the purchasers or developers are contractually

obligated to adhere and which are enforceable by X.

The manner in which X has acquired, used, and proposes to liquidate the property is contrary to the short turn around period experienced by a typical buyer and seller of real property. 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. The fact that X is unable to identify a definite time by which it will complete the sale of the property is attributable to various factors, including those involving decisions to be made by governmental units regarding programs that are impacting the Land and surrounding area. X's procuring an engineering plan serves not only to provide the trustees with information needed to achieve maximum value consistent with X's fiduciary duties, but allows X to determine how best to ensure that the land will be used in a manner that is consistent with its charitable purposes. X will divide the property into parcels, which will not require or involve any construction on the property. No improvements are contemplated to enhance sale of the property. Purchasers and developers of the property would construct all site improvements, e.g., grading, paving, excavation, utilities, etc. including roads and utilities, at their expense.

The engineering plans that X procured and the division of the property are essential to the trustees' being able to administer the property in a manner that best furthers the charitable purposes of X. The facts distinguish the proposed transaction from the sale of property held primarily for sale to customers in the ordinary course of business. 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, and that income from the sale of this property is excluded from the computation of unrelated business taxable income by reason of section 512(b)(5) of the Code.

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

1. X's procurement of detailed site engineering plans for the Land and division of the Land into parcels through the local government's required procedures will not cause the Land to be held primarily for the sale to customers in the ordinary course of a trade or business within the meaning of section 512(b)(5) of the Code.
2. Sale or long-term lease of the Land over time, in undeveloped parcels, for further improvement, subdivision, or development by others will not result in gain realized on the sale(s) being taxed as unrelated business taxable income under section 511 of the Code and should be excluded from the computation of unrelated business taxable income under section 512(b)(5) of the Code.

This ruling applies the applicability of sections 511-513 to the facts represented

above. We express no opinion as to the tax consequences of the transaction 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 your activities, you should keep a copy of this ruling in 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,

Jane Baniewicz
Manager, Exempt Organizations
Technical Group 2