

Unrelated income; debt-financed property; rental income related to exempt purpose. An exempt organization that was created by a chamber of commerce to encourage business development in a particular area obtained a mortgage to help finance the construction of a building that is leased to an industrial tenant at less than the fair rental value. The leasing of the property is substantially related to the organization's exempt purpose, and the property is not debt-financed property. Rev. Rul. 70-81 amplified.

ISSUE

Does property leased to an industrial tenant by an organization exempt from federal income tax under section 501(c)(6) of the Internal Revenue Code, under the circumstances described below, constitute debt-financed property within the meaning of section 514(b)(1)?

FACTS

The organization was created by a chamber of commerce that is also exempt under section 501(c)(6) of the Code. The organization's stated purpose is to promote, encourage, and aid industrial, commercial, and business development in the metropolitan area in which it is located.

The organization's primary activity is the carrying on of a program of encouraging new industries to move to the area. As part of this program, the organization constructed a shell building, on land donated to it by the city. The construction of the building was financed by contributions to the organization from the members of the chamber of commerce. The organization had no obligation to the members on account of these contributions. The primary purpose of this activity by the organization was to attract new industry to the area by offering to lease the building at a rent to a tenant that is lower than fair market value under similar circumstances.

The organization subsequently entered into a lease agreement with an industrial tenant. Under the terms of the lease, the organization completed the shell building to suit the needs of the tenant. The completion of the building was financed by subjecting the property to a mortgage.

LAW

Section 514(b)(1) of the Code 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 as defined in section 514(c).

Section 514(c)(1)(A) of the Code provides that the term

'acquisition indebtedness' means, with respect to any debt-financed property, the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property.

Section 514(b)(1)(A)(i) of the Code excludes from the definition of debt-financed property 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 the purpose or function constituting the basis for its exemption.

Section 1.514(b)-1(b)(1) of the Income Tax Regulations provides that, in determining whether the exclusion set forth in section 514(b)(1)(A)(i) of the Code is applicable, the principles in section 1.513-1 of the regulations should be applied in determining whether there is a substantial relationship between the property and the exempt purpose of the organization.

Section 1.513-1(d)(2) of the regulations provides 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 a trade or business to be substantially related to the 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 these purposes.

Section 1.501(c)(6)-1 of the regulations provides that a chamber of commerce is an association of persons having some common business interest, the purpose of which is to promote such common business interest and not to engage in a regular business of a kind ordinarily carried on for profit.

Rev. Rul. 70-81, 1970-1 C.B. 131, holds that the acquisition, development, and sale of sites in an industrial park by a chamber of commerce exempt from federal income tax under section 501(c)(6) of the Code, in a manner designed to attract new industry to the community, is in furtherance of the chamber's exempt purpose of improving the general business conditions of the community.

ANALYSIS

The building that the organization owns may constitute 'debt-financed property' within the meaning of section 514(b)(1) of the Code since such property is held to produce income and is subject to acquisition indebtedness. Thus, it is necessary to determine whether substantially all of the use of the building is substantially related to the exercise or performance by the organization of the purpose or function constituting the basis for its exemption, and therefore excluded from the definition of debt-

financed property under the provisions of section 514(b)(1)(A)(i).

As in the case of the sale of the industrial park lots discussed in Rev. Rul. 70-81, the leasing of the building by the organization, under the circumstances described, when the project is initially financed by contributions from the business community and is leased at less than fair market value for similar facilities, is an activity designed to attract industry to the community and is not an activity of a kind ordinarily carried on for profit. The activity therefore contributes importantly to the purposes constituting the basis for the organization's exempt status under section 501(c)(6) of the Code, and thus is substantially related to those purposes within the meaning of section 514(b)(1)(A)(i).

HOLDING

Property leased to an industrial tenant by an organization exempt from federal income tax under section 501(c)(6) of the Code, under the circumstances described above, does not constitute debt-financed property within the meaning of section 514(b)(1).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 70-81 is amplified.