



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200532057**
Release Date: 8/12/05
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Date: 05/16/05

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Uniform Issue List:

511.00-00
512.00-00

Legend:

M =

N =

P =

X =

Y =

Dear _____ :

We have considered your ruling request dated August 4, 2004, in which you requested a ruling on the effect on your exempt status and your liability for the tax on unrelated business income of certain real estate transactions.

M is exempt from federal income tax under section 501(c)(3) of the Code, and is classified as an organization described in section 509(a)(1) and 170(b)(1)(A)(i). M is subject to the tax imposed by section 511(a)(1) on any unrelated business income M may have. M was founded in 1937 and became affiliated with N in 1942. M engages in a variety of religious, educational and community activities. The primary source of funding is from individual parishioners. M does not receive grants from outside sources.

M has owned two contiguous properties in P over the past fifty years. The first was a pair of converted houses, which became overcrowded. M purchased its present site with four buildings in 1972 to accommodate a growing congregation. The facilities have

been used as a worship/fellowship building, an office/residence for the church offices and pastor, a gymnasium and a recreation hall. M's buildings were constructed in the 1940s and the facilities have not been updated or remodeled and are behind in modern codes for accessibility.

In 2002, M decided to remodel and update the existing buildings. In preparing to remodel one of the existing structures, M discovered that due to the building's age, significant damage had been done to the building causing it to become unsafe to use. Estimates place the cost for necessary repairs and improvements at approximately x dollars. M determined that it would need to sell part of the land in order to finance the remodeling.

M's annual income is only approximately y dollars. While the property is nearly free of encumbrances, M's annual income and reserves is not sufficient to fund such renovations. M has determined that the most appropriate means to finance the project is to sell part of the property in order to finance the necessary repairs, construction and improvements.

M's property is zoned for single family residences. The proposed plan includes subdivision of the property into seven parcels, including six single family residences. One of the parcels will be retained by M. Under the proposed plan, P requires that M grade and construct 1,190 linear feet of new curb, gutter, sidewalk, drainage, water and electrical improvement. M plans to make the required improvements to the lots and then sell the parcels without additional improvement to a developer, or to individuals.

M states that this will be a one-time activity. Any proceeds would be used by the church for its place of worship, education and recreation services. Any excess would be used for building repairs and maintenance.

You have requested the following rulings:

1. The sale of the property as described will not adversely affect the M's tax-exempt status under section 501(c)(3) of the Code.
2. The development and sale of bare lots to individuals will not be unrelated business taxable income under section 511 and section 512 of the Code and will not be taxable to the M.

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 inure 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 512) 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).

The modifications described in section 512(b)(5) of the Code exclude from 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 includible 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 1.513-1(a) of the Income Tax Regulations defines the term “unrelated business taxable income” as used in section 512 of the Code, as meaning the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. The term “unrelated trade or business” means 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 its charitable, education, or other purpose or function constituting the basis for exemption.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is “regularly carried on,” within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities are conducted and the manner in which they are pursued.

Section 1.513-1(c)(2)(ii) of the regulations provides that in determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.

Section 1.513-1(d)(1) of the regulations states that to be regarded as unrelated trade or business activity the conduct of the activity would not be substantially related to the organization’s exempt purposes. To determine whether a business activity is or is

not substantially related requires an examination of the relationship between the business activities which generate the particular income and the accomplishment of the organization's exempt purpose.

In Brown v. Commissioner, 143 F.2d 468 (5th Cir. 1944), the taxpayer owned 500 acres of unimproved land used for grazing purposes. The taxpayer listed the land for sale with a licensed real estate broker whom the taxpayer 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. The court held that the taxpayer 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 the taxpayer did not buy additional land did not prevent the sales activities from being a business .

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. 55-449, 1955-2 C.B. 599 in describing the construction and sale of 80 houses by a charitable foundation described in section 101(6) of the 1939 Code (the predecessor to section 501(c)(3)), over a period of 18 months for the sole purpose of raising funds for the support of a church, holds that such activity constitutes unrelated trade or business, notwithstanding that the foundation does not contemplate engaging further in such activity. Where the activity constitutes the primary activity, the foundation is not entitled to exemption.

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.

Under the facts provided, M proposes to sell land that it acquired for its charitable purposes and which it has held for a significant period of time. Due to M's need to generate proceeds to fund necessary renovations, M determined that it is in its best interest to sell the land in order to fund these activities. The facts surrounding M'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.

M will make only the improvements to the land as required by P in order to receive approval and make the property saleable. M plans to sell the lots to individuals after the required improvements. No other improvements are contemplated to enhance the sale of the property.

Applying the facts and circumstances test and the primary purpose test of Malat,

supra, we have concluded that the proposed development and sale of the property as described herein will not adversely affect M's tax-exempt status under section 501(c)(3) of the Code. Nor does the proposed sale of the bare lots to individuals constitute unrelated business taxable income under sections 511 and 512 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 sale of the property as described will not adversely affect M's tax-exempt status under section 501(c)(3) of the Code.
2. The sale of parcels to individuals or developers with the limited improvements as described will not be unrelated business taxable income under section 511 and section 512 of the Code and will not be taxable to M.

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 will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to M, the organization that requested it. Section 6110(k)(3) of the Code 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,

Jane Baniewicz
Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437