



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

UIL: 501.02-00

Number: **200621031**
Release Date: 5/26/06
Date: March 1, 2006

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

X =
Y =

Dear _____ :

This is in reference to a ruling request dated July 18, 2005 as modified by a letter dated December 2, 2005, submitted by your authorized representative concerning the federal tax consequences of rental income received from multi-use real property.

The information provided indicates you (the "Company") are a title-holding corporation exempt from federal income tax under section 501(a) of the Internal Revenue Code ("Code") as an organization described in section 501(c)(2) of the Code. The Company's parent and one hundred percent owner is X, a fraternal society exempt under section 501(a) as an organization described in section 501(c)(8). X is affiliated with Y a national fraternal organization operating under the lodge system.

Facts:

The Company is the owner of real property and improvements currently used by X as a lodge facility. X has approved construction of a multi-use facility on the property that will be used as residential apartment rentals and as a new lodge facility. The current development plan will involve the construction/improvement of two premises on the property. To finance the construction of this development, you will borrow necessary funds from an outside, independent third party lender.

One building will be used entirely as residential rental apartments. X will retain the use of the first floor and basement of the second building while the remaining six levels of that building will be used as residential rental apartments. The development will include 76 apartments and 38 parking spaces. Qualified independent and unrelated third parties will be hired to handle all management activities in connection with the rental of residential apartments. X will also hire

appropriated maintenance personnel. The Company will provide general building and grounds maintenance and furnish utilities such as electricity and gas.

Tenants wishing to secure off-street parking in the development will pay an additional fee in addition to the rent stipulated in the lease agreement. Parking spaces will be offered on a first come first serve basis. Parking spaces will not be available to members of the general public.

As part of an arrangement with Y, X will be entitled to retain 49% of the net rental income from the development. This income will be used for the exempt functions and purposes of X and for distributions to one or more local and national tax-exempt section 501(c)(3) charities. The remainder of the net rental income will be distributed to Y or to one or more section 501(c)(3) entities of Y's choosing.

Law:

Section 501(c)(2) of the Internal Revenue Code (the "Code") provides for the exemption from federal income tax of corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses to an organization which itself is exempt under this section. Rules similar to the rules of subparagraph (G) of paragraph (25) shall apply for purposes of this paragraph.

Under section 501(c)(25)(G) of the Code an organization shall not be treated as failing to be described in section 501(c)(2) by reason of the receipt of any otherwise disqualifying income which is incidentally derived from the holding of real property which does not exceed 10 percent of the organization's gross income for the taxable year.

Section 1.501(c)(2)-1(a) of the Income Tax Regulations (the "regulations") provides that since a corporation cannot be exempt under section 501(c)(2) if it engages in any business other than that of holding title to property and collecting income therefrom, it generally cannot have unrelated business taxable income as defined in section 512 other than unrelated business rental income described in section 514.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(2).

Section 512(b)(3) of the Code modifies the definition of unrelated trade or business by excepting all rents from real property.

Section 1.512(b)-1 of the regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case.

Under section 1.512(b)-1(c)(2) of the regulations the term rents for purposes of section 512(b) includes all rents from real property. However, certain rents from, and certain deductions in connection with, debt-financed property (as defined in section 514(b)) shall be

included in computing unrelated business taxable income.

Section 1.512(b)-1(c)(5) of the regulations provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

Section 514(b)(1) of the Code defines debt-financed as 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, except that such term does not include property where substantially all of the use is related to the charitable, educational or other purpose of the organization under section 501.

Rev. Rul. 69-381, 1969-2 C.B. 113 held that income from the rental of offices to the general public did not preclude exemption from federal income tax under section 501(c)(2) of the Code where the title holding corporation did not render substantial services to the tenants other than the normal maintenance of the building and grounds. The general public tenants were not related in any way to the title holding company or the charitable organization for which it holds title.

Analysis:

Considering the statutory language providing the exemption for title holding companies that requires the organization to turn over the income from property to a tax exempt organization it was clearly understood that income would be received from parties other than the exempt organization for which it holds title. See Rev. Rul. 69-381. Since X and Y are structurally related to each other they may reasonably be considered "an organization" for purposes of section 501(c)(2) of the Code.

The only services provided by X for the tenants of the rental units will be those customarily associated with the rental of real property such as general maintenance and utilities. Therefore, under Reg. 1.512(b)-1(c)(5), the income received by X for occupancy of the rental units will be rents from real property which are excluded from the unrelated trade or business income under section 512(b).

Generally, the receipt of revenue from the operation of a parking lot by an exempt organization will not produce "rent" as defined in section 512(b)(3) of the Code. However,

section 1.512(b) -1 of the regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. Here, parking fees will be received only from designated tenants of the residential units for spaces adjacent to the units. X will not be operating a parking lot for the use of the general public. Therefore, the additional income from parking fees should be considered part of the rent.

Thus, income from the rental of residential units and the associated parking fees will not jeopardize the Company's exemption from federal income tax as an organization described in section 501(2) of the Code. However, to the extent the income is derived from debt-financed property, the income will be included in the computation of unrelated business taxable income as provided in section 514.

Conclusions:

1. Rental income received annually by the Company from residential apartments and from the residents parking will not result in disqualifying income under sections 501(c)(2) or 501(c)(25) of the Code.
2. The Company may pay, out of the net rental income realized, forty-nine (49) percent to X and fifty-one to Y, or directly to a section 501(c)(3) entity or entities designated by Y, without losing its tax-exempt status.
3. If the construction of the buildings described herein is debt-financed, the net income realized from the rental of the residential apartments and residents' parking is included in the computation of unrelated business taxable income.
4. Once the debt-financing has been fully paid, the rental income from apartments and residents parking will cease to be considered unrelated business taxable income. 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 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.

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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,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437