



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **200843036**
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Uniform Issue List:
514.01-00
514.06-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

SE:T:EO:RA:T:2

Legend:

M =
R =
S =
T =
V =

X =
Y =
Z =

Dear _____ :

We have considered your ruling request dated February 27, 2008 and supplemental information dated May 1, 2008 and July 22, 2008, requesting a ruling that rental income from a proposed rental will not be treated as unrelated business taxable income under section 514(b)(1)(A) of the Internal Revenue Code.

Facts:

M is an organization exempt under section 501(c)(3) of the Code whose mission is to provide people with disabilities and other barriers the opportunity to achieve personal and economic independence through the use of education, training and employment services. In furtherance of its mission, M provides education and employment services to deaf persons, offers vocational training to persons with various disabilities, and employs M trained workers in various business activities.

As part of its activities, M obtained federal set-aside contracts through R, which requires that at least x% of its direct labor be performed by persons suffering from severe disabilities. To meet the percentage of labor requirement under the R contracts, M caused S to be formed. S is recognized as exempt under section 501(c)(3) of the Code with the purpose of assisting persons with severe disabilities obtain productive and valuable training and employment. With the formation of S, several of M's employees with severe disabilities were employed by S

providing T. The majority of S's employees in T were trained in the rehabilitation programs provided by M. M has provided a representation that S is not a "controlled entity" under section 1.512(b)-1(1) of the Income Tax Regulations.

M secured tax-exempt bond financing to replace a mortgage which it obtained to purchase a building primarily to house a new fitness center. The building is used to provide assistance, services and employment to people with disabilities. Approximately, y% of the square footage will house the fitness center and an already existing program, V.

In addition to housing the new fitness center, M intends to lease z% of the square footage of the building to S to house its T business. M states that without the proposed rental, the space otherwise be unoccupied.

The building and fitness center will be owned and operated by M. All of the programs operated in the building including T will be managed by M employees through a written cost-sharing agreement with S.

The new fitness center is meant to enhance M's ability to achieve its mission by providing specially designed equipment and personnel specially trained to help persons with disabilities rebuild physical strength and stamina, making it possible for them to return to their usual and customary activities such as school, work, leisure, and activities of daily living. M has a physical therapist on staff to offering services as prescribed by a physician and a consulting physician will be provide advisory services. The building is a fully accessible facility and barrier free complying with federal guidelines. The facility is open to community members who have a medically diagnosable disability or chronic illness. The facility is also open to employees of M and S.

Ruling Requested:

You have requested a ruling that the rental income M receives from S will not be treated as unrelated business taxable income under the "substantially related use" exception in section 514(b)(1)(A) of the Code.

Law:

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 unrelated trade or business taxable income as the gross income derived by any organization from any unrelated trade or business regularly carried on by

it, less the allowable deductions directly attributable to such business activity, with certain modifications.

Section 512(b)(3) of the Code provides that rents from real property (and its incidental related personal property) are not treated as unrelated business income unless the real property is debt-financed under section 514. Debt-financed property does not include any property substantially related to the exercise or performance by such organization of its charitable functions.

Section 513(a) of the Code defines unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of the organization for funds or the use it makes of the profits derived) to the exercise of the organization's exempt purposes or functions.

Section 514 of the Code defines unrelated debt-financed income as income produce from debt-financed property from an unrelated business, as discussed in section 512.

Section 514(b)(1)(A) of the Code defines the term "debt-financed property" to mean property that is held to produce income and with respect to which there is an "acquisition indebtedness", except that such term does not include 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 its charitable, educational, or other exempt purposes.

Section 1.512(b)-1(1) of the Income Tax Regulations provides that if an exempt organization has control of another organization, the controlling organization shall include as an item of gross income in computing its unrelated business taxable income the amount of interest, annuities, royalties, and rents derived from the controlled organization, determined in accordance with the formula described in section 512(b)(13) of the Code and section 1.512(b)-1(1) (3) of the regulations.

Section 1.513-1(d)(2) of the regulations provides, in part, that a trade or business is related to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes; 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 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 exempt purposes.

Section 1.514(b)-1(b)(1)(ii) of the regulations excludes from the definition of "debt-financed property" any property the use of which is substantially related to the exercise or performance of an organization's charitable, educational, or other exempt purpose if 85 percent or more of such property is devoted to the organization's exempt purposes.

Rev. Rul. 69-434, 1969-2 C.B. 132 holds that leases of office space by an exempt hospital to

members of its medical staff were substantially related to the performance of hospital functions and therefore were not business leases under section 514 of the Code. The hospital built with borrowed funds an adjacent office building in order to encourage its medical staff to maintain their private medical practices near the hospital. The close proximity of the offices of the medical staff resulted in greater use made of the hospital's diagnostic facilities, easier patient admissions, more availability of the medical staff's services for outpatient and inpatient emergencies, facilitation of their everyday medical duties in the hospital, and increase in their participation in the hospital's medical education and research programs.

Analysis:

An organization's leasing of its property to others may be substantially related to the performance of its exempt function. Section 514(b)(1)(A) of the Code provides that "debt-financed property" does not include any property substantially all the use of which is substantially related to the exercise or performance by such organization of its charitable, educational, or other exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is substantially related to an organization's exempt purpose if there is a substantial causal relationship between the conduct of the business and the achievement of the exempt purpose. That is, the conduct of the business must contribute importantly to the accomplishment of the organization's exempt purposes.

M's exempt purpose is to help person with disabilities achieve independence through education, training and employment. The building will house a fitness center with equipment specially designed for persons with disabilities. The facility is open to those in the community with a diagnosable disability or chronic illness with the exception of membership being open to employees of M or S. The fitness center and the V program offered by M help persons with disabilities, furthering M's exempt purpose of assisting persons with disabilities.

S's purpose is to provide persons with severe disabilities with training and employment. Many of S's workers are disabled and of those employed in its I business, the majority are M trained and educated persons. M has provided a representation that S is not a controlled entity under section 1.512(b)-1(1) of the regulations. The proposed rental to S is comprised of z% of space to be used in S's I business, which employs many people educated and trained by M. The building will be occupied only by M and S. The use of the space by S will thereby continue the employment of persons educated and trained by M. S's activities help further M's exempt purpose by providing employment opportunities to severely disabled persons. Therefore, the entire building will be used to further M's exempt purpose.

Conclusion:

Based on the foregoing, we rule that the rental income M receives from S will not be treated as unrelated business taxable income under the "substantially related use" exception in section 514(b)(1)(A) 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 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.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. Because it could help resolved questions concerning your federal income tax status, this ruling should be kept 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,

Ronald J. Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437