



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

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Foundation =

Date 1 =

Date 2 =

Society =

City =

County =

X =

Y =

Dear

This letter is in reference to a letter dated May 7, 2009, in which Foundation requests a ruling that the construction, ownership, and operation of a community activity center, as described below, will not adversely affect its exempt status under section 501(c)(3) of the Internal Revenue Code (the "Code") or result in unrelated business income tax under section 511 of the Code.

Facts:

Foundation is an organization recognized by the Internal Revenue Service (the "IRS") as exempt from federal income tax under section 501(c)(3) of the Code. Foundation was incorporated on Date 1 to provide disaster relief throughout the United States and to operate exclusively for charitable and educational purposes. On Date 2, Foundation amended its Articles of Incorporation to include the following purpose:

To acquire and/or construct, own and operate community activity centers in communities throughout the United States, offering a broad range of programs, services and activities designed to serve community members of all ages to develop the physical, social and intellectual well being of the community, with membership open to all members of the

community and affordable to a broad segment of the community.

Under the terms of Foundation's bylaws, each director of Foundation's Board of Directors is appointed by, and may be removed by, the Executive Committee of Society. Society is a fraternal beneficiary society recognized by the IRS as exempt from federal income tax under section 501(c)(8) of the Code. Foundation states that Society has more than x lodges throughout the United States whose members conduct volunteer, charitable, and patriotic projects benefiting individuals, families, and communities throughout the country.

Foundation states that it desires to expand its exempt purpose activities by acquiring and/or constructing, owning, and operating a community activity center located in City and County (the "Center"). The Center will be built on land acquired from an independent third party in an arm's length transaction for a purchase price that reflects fair market value. The Center will be financed from the proceeds of long-term bonds and contributions from City and County.

The Center will offer a broad range of programs, services, and activities designed to serve community members of all ages to develop the physical, social, intellectual, and emotional well being of the community. The programs, services, and activities to be provided include, without limitation, the following:

- facilities for exercise and fitness, along with related group programs and classes focusing on community health and wellness education;
- a variety of other educational programs for all age groups, including individual and group exercise and fitness programs, health risk/lifestyle assessments, youth fitness programs and diet and nutrition education programs that promote and encourage health lifestyles and lifetime wellness;
- youth day camps, sports camps, and other educational camps for youth;
- a range of charitable services to the community, including meals-on-wheels programs, food bank drives, and blood drives;
- space for charity events and disaster relief activities (such as Red Cross blood drives, community emergency response team meetings, and Red Cross emergency shelters);
- space that can be used for community activities, including nonprofit organization fundraising events and activities, community social activities and local school activities (such as swim meets and other local school sporting events that can be accommodated at the Center);
- after-school and tutoring programs for children; and
- sports leagues, including youth baseball, softball, indoor soccer, and volleyball leagues.

Foundation states that membership in the Center will be open to all residents of the community, with a wide range of activities available depending on a member's level of membership. Foundation anticipates that memberships will be offered on a month-to-month basis. Although different levels of membership will be available at different costs, there will be no membership level that offers exclusive services that would be affordable to only a limited number of members of the community. Each membership level will generally give members

access to a broad range of particular services within that membership class (e.g. one membership level may provide access to the fitness center, gymnasium, and youth sport camps, while another level may provide access to the fitness center, gymnasium, and swimming pool). Foundation states that all members of the community will pay the same membership fee for a particular membership level regardless of their affiliation with a Society lodge, resulting in consistent membership fees for all members that will be more affordable to the community as a whole. Foundation states that because membership fees at each level will be determined based on cost and not on profitability with the necessity of achieving a specified return on investment, Foundation will charge the lowest feasible membership fees possible, taking into account only the actual cost of the services provided. City will make available a limited number of scholarships to members of the community who are otherwise unable to afford the Center's membership fees. According to City representatives, scholarship eligibility requirements will be similar to the eligibility requirements for the free lunch program within City's public school system. In addition, Foundation intends to provide financial assistance to members of the community to the extent it has the financial capability to do so, taking into account expenses related to the operation of the Center.

Foundation states that it will provide meeting space to local nonprofit organizations (such as local chapters of the American Red Cross, the United Way and its affiliated agencies, local chambers of commerce, Boy Scouts, and local historical associations) to the extent space is available. Foundation will charge these organizations the actual cost of providing the space. Foundation will also lease the Center's banquet room to individuals and groups for private functions, but will provide no services to the lessees.

Foundation has entered into a written agreement with City (the "Agreement") under which City will be responsible for the hiring, supervision, and direction of all personnel working at the Center and any other persons performing City's duties under the Agreement. City will be responsible for complying with City personnel guidelines and all applicable laws in performing its duties under the Agreement. Foundation will have the right to provide input to City regarding employment of the Center's manager, programmer, and director of marketing.

City will relocate its recreation department's administrative offices to space in the Center. Under the Agreement, City will make a one-time payment to Foundation in the amount of \$y. Foundation represents that the City's administrative offices will occupy less than fifteen percent of the total area of the Center.

In addition to the foregoing activities, Foundation states that it may lease a limited amount of office space within the Center to Employees and/or Independent Contractors of Society. Employees are employees of Society, while Independent Contractors enter into independent contractor arrangements with Society. Any lease with Employees or Independent Contractors will be for space only and will not include any personal property. Foundation represents that no more than 10 percent in the aggregate of the total usable square footage of any center will be used for such purpose. The terms and conditions of each lease would reflect fair market value, and Foundation would obtain confirmation of fair market value rental rates for the lease of such office space from qualified and independent third parties who have knowledge of the local rental market.

Rulings Requested:

Foundation requests the following rulings:

- (1) Foundation's expansion of its activities to include the acquisition and/or construction, financing, ownership, and operation of a community activity center in City that will be available to all members of the community and affordable to a broad segment of the members of the community, as described above, will not adversely affect Foundation's exempt status under section 501(c)(3) of the Code.
- (2) The income derived by Foundation from its ownership and operation of the community activity center, as described above, will not be subject to the unrelated business income tax imposed by section 511 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, educational, and other specified exempt purposes so long as no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 511(a)(1) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3).

Section 512(a)(1) of the Code provides that, except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(3)(A)(i) of the Code provides that there shall be excluded from the definition of unrelated business taxable income all rents from real property.

Section 512(b)(4) of the Code provides, in part, that notwithstanding section 512(b)(3), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1).

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds of the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 514(b)(1) of the Code provides, in general, that for purposes of section 514, the term “debt-financed property” means 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--(A)(i) any property substantially all of 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 purpose or function constituting the basis for its exemption under section 501, or (ii) any property to which clause (i) does not apply, to the extent that its use is so substantially related.

Section 514(b)(2) of the Code provides that, for purposes of applying section 514(b)(1)(A), the use of any property by an exempt organization which is related to an organization shall be treated as use by such organization.

Section 514(c)(1)(A) of the Code defines the term “acquisition indebtedness,” with respect to any debt-financed property, as the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations (the “regulations”) provides that an organization will be regarded as “operated exclusively” for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term “charitable” is used in section 501(c)(3) of the Code in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of “charity” as developed by judicial decisions.

Section 1.501(c)(3)-1(d)(3)(i) of the regulations provides, in part, that the term “educational,” as used in section 501(c)(3) of the Code, relates to the instruction or training of the individual for the purpose of improving or developing his capabilities. One example is an organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs.

Section 1.512(b)-1(c)(2) of the regulations provides, in part, that all rents from real property, and the deductions directly connected therewith, shall be excluded in computing unrelated business taxable income. However, certain rents from and certain deductions in connection with debt-financed property (as defined in section 514(b) of the Code) shall be included in computing unrelated business taxable income.

Section 1.512(b)-1(l)(4) of the regulations defines “control” for purposes of section 1.514(b)-1(c)(2)(ii)(b). In the case of a nonstock organization, the term “control” means that at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization. A trustee or director is a representative of an exempt organization if he is a trustee, director, agent, or employee of such exempt organization. A trustee or director is controlled by an exempt organization if such

organization has the power to remove such trustee or director and designate a new trustee or director. Section 512(b)(13) of the Code was subsequently revised to define "control" as 50 percent of the beneficial interests in an entity.

Section 1.513-1(d)(1) of the regulations provides that gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a 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 the goods or the performance of the services does not derive from the conduct of related trade or business.

Section 1.513-1(d)(4)(i) of the regulations provides that gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business.

Section 1.514(b)-1(b)(1)(i) of the regulations provides that, to the extent that the use of any property is 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 an organization of its charitable, educational, or other purpose or function constituting its basis for exemption under section 501 of the Code, such property shall not be treated as "debt-financed property."

Section 1.514(b)-1(b)(1)(ii) of the regulations provides that if substantially all of any property is used in a manner described in section 1.514(b)-1(b)(1)(i), such property shall not be treated as "debt financed property." In general, the preceding sentence shall apply if 85 percent or more of the use of such property is devoted to the organization's exempt purpose. The extent to which property is used for a particular purpose shall be determined on the basis of all the facts and circumstances. These may include (where appropriate)—

- a. A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,
- b. A comparison of the portion of such property that is used for exempt purposes with the portion of such property that is used for all purposes, or
- c. Both the comparisons described in (a) and (b) of this subdivision.

Section 1.514(b)-1(c)(2)(i) of the regulations provides that property owned by an exempt organization and used by a related exempt organization or by an exempt organization related to

such related exempt organization shall not be treated as "debt-financed property" to the extent such property is used by either organization in furtherance of the purpose constituting the basis for its exemption under section 501 of the Code.

Section 1.514(b)-1(c)(2)(ii)(b) of the regulations provides that, for purposes of section 1.514(b)-1(c)(2)(i), an exempt organization is related to another exempt organization if one organization has control of the other organization within the meaning of paragraph (l)(4) of section 1.512(b)-1. Again, section 512(b)(13) of the Code subsequently amended the definition of "control."

Section 1.514(c)-1(a)(1) of the regulations defines "acquisition indebtedness," with respect to debt-financed property, as the outstanding amount of (i) the principal indebtedness incurred by the organization in acquiring or improving such property, (ii) the principal indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement, and (iii) the principal indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonable foreseeable at the time of such acquisition or improvement.

Rev. Rul. 59-310, 1959-2 C.B. 146, describes an organization organized for the purpose of establishing, maintaining, and operating a public swimming pool, playground, and other recreation facilities for the children and other residents of a particular community. Residents of the community making use of such facilities consist principally of low-income groups who are unable to pay the cost of privately sponsored recreation facilities for themselves and their children. The revenue ruling concludes that since the property and its uses are dedicated to members of the general public of the community and are charitable in that they serve a generally recognized public purpose which tends to lessen the burdens of government, the organization is entitled to exemption under section 501(c)(3) of the Code.

Rev. Rul. 79-360, 1979-2 C.B. 236, describes an organization whose purpose is to provide for the welfare of young people by the conduct of charitable activities and maintenance of services and facilities that will contribute to their physical, social, mental, and spiritual health, at a minimum cost to them. Membership in, and the services and facilities of, the organization are available upon payment of nominal annual dues. The organization has recreational facilities that are used in its general physical fitness programs. Members use these facilities as often as they wish. However, the organization has also organized a health club program that its members may join for an advance annual fee that is sufficiently high to restrict participation to a limited number of the members of the community. The annual fee is comparable to fees charged by similar local commercial health clubs. The advance fee is in addition to the nominal annual dues for membership in the organization. In addition, those who are not health club members pay admission fees comparable to fees charged by similar local commercial health club facilities each time they use any of the health club facilities. The ruling states that, because the commercially comparable annual dues or daily fees charged are sufficiently high to restrict the health club's use to a limited number of the members of the community, the operation of the health club program does not contribute importantly to the accomplishment of the organization's exempt purposes. Consequently, the operation of the health club facilities is unrelated trade or

business within the meaning of section 513 of the Code.

In Isabel Peters v. Comm'r, 21 T.C. 55 (1953), the Tax Court held that providing convenient swimming and recreation facilities for all persons residing in the particular school district, and especially for those who could not afford to acquire and maintain such facilities, was "charitable" as defined under section 501(c)(3) of the Code since it promoted the social welfare of the community.

Analysis:

Foundation intends to embark on a broad range of programs, as described above, through its Center in City. Programs such as exercise and fitness programs, diet and nutrition education programs, sports leagues, after-school tutoring programs, meals-on-wheels programs, and others further charitable and educational purposes within the meaning of section 501(c)(3) of the Code and sections 1.501(c)(3)-1(d)(2) and (3) of the regulations.

Membership is required for use of the Center. Fees will be charged, and different levels of membership will be available at different fees. An exempt organization operating community recreational facilities may qualify for exemption under section 501(c)(3) of the Code on the grounds that its activities are charitable so long as all members of the community are eligible to use the facilities. See Rev. Rul. 59-310 and Isabel Peters above. However, the operation of a community activity center would not be substantially related (within the meaning of section 1.513-1(d) of the regulations) to the exercise or performance of charitable functions if the facility charges fees sufficiently high to restrict usage of the facility to a limited number of members of the community. See Rev. Rul. 79-360, above.

The Center is intended to be a true "community" center available to all members of the community as demonstrated by the fact that the Center will be staffed and operated by employees of the City, and will host the offices of the City's recreation department. Although the Center will have different levels of membership available at different costs, there will be no membership level that offers exclusive services that will be affordable to only a limited number of members of the community. Each membership level will give members access to a broad range of services within that membership class. Membership fees at each level will be determined based on the actual cost of making the facility and the specific range of services available at a particular membership level. Some financial assistance and scholarships will be offered to community members who are unable to afford the membership fee. Thus, the Center memberships will benefit a significant segment of the local population.

Since the activities to be conducted at the Center will accomplish Foundation's charitable and educational purposes (within the meaning of section 1.502(c)(3)-1(c)(1) of the regulations), the operation of the Center will not adversely affect Foundation's exempt status under section 501(c)(3) of the Code. Further, since those activities will contribute importantly to the accomplishment of Foundation's exempt purposes, they will be substantially related (within the meaning of section 513 of the Code and section 1.513-1(d)(2) of the regulations) to Foundation's exempt purposes. Therefore, membership income and other income derived from charitable and educational programs conducted at the Center, being income derived from the performance of exempt functions under section 1.513-1(d)(4)(i) of the regulations, will not be



considered income from the conduct of an unrelated trade or business under section 512.

Foundation will lease a limited amount of office space in the Center to Employees and/or Independent Contractors of Society. Foundation will also lease meeting space to community nonprofit organizations. Foundation will lease its banquet room to individuals and groups for private purposes. Although rents from real property are generally excluded from unrelated business income tax by section 512(b)(3) of the Code, when rents are derived from debt-financed property, a portion of such rents, in an amount determined under section 514(a), must be included under section 512(b)(4) as an item of gross income derived from an unrelated trade or business.

The Center will be financed in large part with the proceeds of long-term bonds. Since such proceeds constitute "acquisition indebtedness" under section 514(c) of the Code, the Center would be considered debt-financed property under section 514(b) unless an exception applied.

Under section 514(b)(1)(A)(i) of the Code, the term "debt-financed property" does not include any property substantially all of the use of which is substantially related to the exercise or performance by an organization of its exempt purpose. Section 1.514(b)-1(b)(1) of the regulations provides that "substantially all of the use" of a property is substantially related to exempt purposes if 85 percent or more of the property is devoted to the organization's exempt purpose. And under section 1.514(b)-1(c)(2), property owned by an exempt organization and used by a related exempt organization is not treated as debt-financed property to the extent such property is used by either organization in furtherance of its exempt purpose.

Foundation's use of the Center will be substantially related to Foundation's exempt purposes. Society's use of its leased space in the Center will be substantially related to Society's exempt purposes. Foundation and Society are "related" exempt organizations within the meaning of sections 1.514(b)-1(c)(2)(ii) and 1.512(b)-1(l)(4) of the regulations and section 512(b)(13) of the Code, because Society controls Foundation by its power to appoint and remove Foundation's directors. Thus, between Foundation and Society, substantially all of the use of the Center will be substantially related to the exempt purposes of Foundation and Society by reason of sections 1.514(b)-1(b)(1) and 1.514(b)-1(c)(2). Even though the hosting of the offices of City's recreation department, the lease of meeting space to local nonprofit organizations, or the occasional lease of the banquet room to private parties is not considered a use of the Center that is devoted to exempt purposes, the extent of such nonexempt use, whether viewed in terms of time or space (as described in section 1.514(b)-1(b)(1)(ii) of the regulations) would, when compared with the exempt use of the Center, constitute less than 15 percent of the total use of the Center. Consequently, the Center will not be considered debt-financed property within the meaning of section 514(b)(1) of the Code, and rents derived from the lease of space within the Center are excludable from unrelated business taxable income by section 512(b)(3) of the Code.

Rulings:

Accordingly, based on the facts and circumstances, we rule that:

(1) Foundation's expansion of its activities to include the acquisition and/or construction, financing, ownership, and operation of a community activity center in City that will be available to all members of the community and affordable to a broad segment of the members of the community, as described above, will not adversely affect Foundation's exempt status under section 501(c)(3) of the Code.

(2) The income derived by Foundation from its ownership and operation of the community activity center in City, as described above, will not be considered unrelated business taxable income under section 512 of the Code or be subject to the unrelated business income tax imposed by section 511.

These rulings are based on the facts as they were presented and on the understanding that there will be no material changes in these facts. Any changes that may have a bearing upon Foundation's tax status should be reported to the IRS. Because it could help resolve questions concerning Foundation's federal income tax status, these rulings should be kept in Foundation's permanent records. Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to Foundation's authorized representative.

Except as we have specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions or under any other provision of the Code.

These rulings 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 these rulings 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.

These rulings are directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that they may not be used or cited as precedent.

If there are any questions about these rulings, please contact the person whose name and telephone number are shown in the heading of this letter.

Enclosure  
Notice 437

Sincerely yours,

Manager, Exempt Organizations  
Technical Group