



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: 201444043

Release Date: 10/31/2014

Date: August 5, 2014

UIL: 502.00-00; 503.00-00; 512.01-01

LEGEND:

University:

LLC:

Dear :

We have considered your ruling request dated February 14, 2014, and as amended on May 9, 2014, requesting rulings under Internal Revenue Code (I.R.C.) §§ 501(c)(3), 502, and 512.

FACTS

You have been recognized by the Internal Revenue Service as tax-exempt under § 501(c)(3) and classified as a supporting organization under § 509(a)(3). Your tax-exempt purpose has been to provide a broad range of financial support (i.e., fundraising, asset administration, investment activities, etc.) for University, which is a college recognized as tax-exempt under § 501(c)(3) and classified as an educational organization under § 170(b)(1)(A)(ii). In addition, your board members also help mentor University students.

LLC is a limited liability company. You are the sole member of LLC. You state that LLC is considered as a disregarded entity for federal tax purposes under Treas. Regs. § 301.7701-3, with LLC's activities attributed to you. LLC purchased land and commercial property (hereafter "Retail Center") adjacent to University's campus from an unrelated third party utilizing a commercial loan and a cash contribution from you. You did not receive any financing from the seller, any person related to the seller, any qualified trust, or any person related to a qualified trust. The Retail Center buildings are leased to tenants, and which leases LLC assumed the rights and obligations of the landlord/lessor at closing. The business reasons for your purchase (through LLC) include (1) the unique opportunity to enhance University's community by investing in property adjacent to University's campus; (2) the opportunity to acquire the property at a favorable price from a distressed seller; and (3) the opportunity to realize a significant return on your investment in the form of both rental revenues and long-term appreciation in the property's value.

Each lease provides for the tenant/lessee to make rental payments to the landlord/lessor for the use of the Retail Center. You affirm that the rents payable under the leases are for occupancy of the retail space, with no portion of the rents being attributable to the use of personal property. The rent for each lease is a fixed amount specified in the applicable lease except that one lease provides for additional rental payments based on gross receipts from the leased premise. Furthermore, none of the leases provide for payments based on net income or profits derived from the leased property. Finally, you state that Retail Center will not be leased to the seller or any affiliate of the seller.

Under the leases, LLC is required to provide certain property management and maintenance services with respect to the Retail Center. The maintenance services include the maintenance of (1) structural portions of the Retail Center, (2) underground utility and sewer pipes, (3) areas of the Retail Center, (4) grounds surrounding the Retail Center, and (5) common areas of the Retail Center. Management services include collecting rents, ensuring lease provisions are enforced, negotiating new leases, and ensuring that common electricity, gas, sewer and other standard utility services are supplied to the Retail Center. Collectively, these activities comprise LLC's "Rental Activities." You state that LLC contracts with a third-party property management company to conduct the Rental Activities. You state that neither you nor LLC will engage in the Rental Activities directly.

You affirm that the acquisition of the Retail Center did not diminish the size and scope or alter the nature of your charitable program. Other than the debt service expenditures and management service fees paid, you expect your expenditures after the acquisition to be substantially similar to your expenditures prior to the acquisition. Review of your financial statements, including your filed Form 990s, shows that prior to the acquisition you conducted a robust charitable program in regard to your annual support of University. You further affirmed that, ultimately, one hundred percent of the net profits from the Retail Center will be contributed to University, its endowment, or otherwise expended on University's behalf.

RULINGS REQUESTED

1. The ownership of the Retail Center by LLC and the conduct of Rental Activities on behalf of LLC will not provide a basis for the revocation of your tax-exempt status under § 501(c)(3).
2. Rental payments to LLC by tenants in accordance with the terms of the leases will not be treated as unrelated business taxable income to you under § 512(b)(3).
3. The conduct of the Rental Activities on behalf of LLC and the payment of rent to LLC under the leases will not cause you to be classified as a feeder organization under § 502.

LAW

I.R.C. § 170(b)(1)(A) (ii) provides for a charitable deduction for an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on,

I.R.C. § 501(c)(3) provides for the exemption from federal income tax of organizations which are organized and operated exclusively for charitable purposes and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

I.R.C. § 502(a) provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under § 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under § 501.

I.R.C. § 502(b)(1) provides that the term "trade or business" shall not include the deriving of rents which would be excluded under § 512(b)(3), if § 512 applied to the organization.

I.R.C. § 509(a)(3) defines a supporting organization as (A) an organization that is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2) of §509(a); (B) is (i) operated, supervised, or controlled by one or more organizations described in paragraph (1) or (2) of §509(a), (ii) supervised or controlled in connection with one or more such organizations, or (iii) operated in connection with one or more such organizations; and (C) is not controlled directly or indirectly by one or more disqualified persons (as defined in § 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2) of § 509(a).

I.R.C. § 511(a)(1) imposes a tax on the unrelated business taxable income of organizations otherwise exempt from Federal income taxation under § 501(c)(3).

I.R.C. § 512(a)(1) defines "unrelated business taxable income" (UBTI) as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business.

I.R.C. § 512(b)(3) excludes certain rents from the calculation of (UBTI). Specifically, in the case of rents—

(A) Except as provided in subparagraph (B), there shall be excluded—

(i) all rents from real property (including property described in § 1245(a)(3)(C)), and
(ii) all rents from personal property (including for purposes of this paragraph as personal property any property described in § 1245(a)(3)(B)) leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

(B) Subparagraph (A) shall not apply—

(i) if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property described in subparagraph (A)(ii), or

(ii) if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).

(C) There shall be excluded all deductions directly connected with rents excluded under subparagraph (A).

I.R.C. § 513(a) defines "unrelated trade or business" to mean any trade or business the conduct of which is not substantially related (aside from the need for income) to the exercise or performance of the organization's exempt purpose or function that constitutes the basis for its exemption under § 501.

I.R.C. § 514(b)(1) For purposes of this section, the term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).

I.R.C. § 514(c)(9)(A) provides that except as provided in subparagraph (B), the term "acquisition indebtedness" does not, for purposes of this section, include indebtedness incurred by a qualified organization in acquiring or improving any real property.

I.R.C. § 514(c)(9)(C) provides that for purposes of this paragraph, the term "qualified organization" means (i) an organization described in § 170(b)(1)(A)(ii) and its affiliated support organizations described in § 509(a)(3);

Treas. Reg. § 1.501(c)(3)-1(e)(1) provides that an organization may meet the requirements of § 501(c)(3) although it operates a trade or business as a substantial part of its activities, *if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in § 513.* In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under § 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. (*emphasis added*).

Treas. Reg. § 1.502-1(a) provides that, in the case of an organization operated for the primary purpose of carrying on a trade or business for profit, exemption is not allowed under § 501 on the ground that all the profits of such organization are payable to one or more organizations exempt from taxation under § 501. In determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of those activities of such organization which are specified in the applicable paragraph of § 501.

Treas. Reg. § 1.512(b)-1(c)(5) defines the rendering of services. For purposes of this

paragraph, 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 those 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.

Treas. Reg. § 1.513-1(b) provides that for purposes of § 513 the term "trade or business" has the same meaning it has in § 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Treas. Reg. § 1.513-1(c) 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 § 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Treas. Reg. § 1.513-1(d)(1) provides that gross income derives from unrelated trade or business, within the meaning of § 513(a), 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. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question--the activities, that is, of producing or distributing the goods or performing the services involved--and the accomplishment of the organization's exempt purposes.

Treas. Reg. § 1.513-1(d)(2) defines the type of relationship required for a trade or business to be substantially related. 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 § 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. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 58-547, 1958-2 C.B. 275, provides that a lease, the parties to which are both exempt from tax under § 501(c)(3) and which otherwise constitutes a business lease within the meaning of § 514, will not be considered as substantially related to the charitable, educational, etc., purposes of the lessor solely because the lessee is likewise an exempt organization. The lease of property under ordinary commercial arrangements does not constitute the exercise of an educational or charitable function in and of itself. The fact that the lessee may be an exempt educational organization does not cause the rental of space thereto to become a related activity on the part of the lessor who may be organized in part for educational purposes.

Rev. Rul. 64-182, 1964-1 C.B. 186, provides that a corporation organized exclusively for charitable purposes derives its income principally from the rental of space in a large commercial office building which it owns, maintains and operates. The charitable purposes of the corporation are carried out by aiding other charitable organizations, selected in the discretion of its governing body, through contributions and grants to such organizations for charitable purposes. *Held*, the corporation is deemed to meet the primary purpose test of § 1.501(c)(3)-1(e)(1), and to be entitled to exemption from Federal income tax as a corporation organized and operated exclusively for charitable purposes within the meaning of § 501(c)(3), where it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources.

ANALYSIS

I. The first issue that needs to be addressed is whether LLC's operation of Retail Center is the operation of an unrelated trade or business. If the operation of Retail Center is an unrelated trade or business, it may jeopardize your exempt purposes if the operation of Retail Center is an unrelated trade or business and a significant part of your activities, so then you are no longer operated for charitable purposes as required under § 501(c)(3).

Section 513(a) defines "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 or 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 § 501. The term "unrelated business income" pertains to income generated from the sale of goods or services as part of a regularly carried on trade or business that is not substantially related to the exempt purpose of the organization. See §§ 511, 512, and 513(a). Although LLC is not an exempt organization, it is a disregarded entity under Treas. Regs. § 301.7701-3 and its activities will be attributed to you. Renting retail space is an activity carried on for profit, thus, constituting a trade or business. As such, because LLC's sole activity is to operate Retail Center, the operation of which is a regularly carried on and is considered a business, you engage in a regularly carried on trade or business. See §§ 1.513-1(b), 1.513-1(c). The only issue remaining is whether operating Retail Center is substantially related to your exempt purposes, aside for your need for the income generated by the collection of rents from the operation of Retail Center. See § 1.513-1(d)(2).

To determine whether the operation of Retail Center and the collection of rents is substantially related to your exempt purpose of supporting University, other than through the

production of income and the use of that income, necessitates an examination of the relationship between the business activities that produced the income and the accomplishment of your exempt purpose. Treas. Reg. § 1.513-1(d)(1). "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." Treas. Reg. § 1.513-1(d)(2). You have not provided facts to support a conclusion that the operation of Retail Center, i.e., the leasing of commercial space to commercial tenants, is substantially related to your exempt purposes other than through the use of lease income to further the financial support of University. Operating a trade or business for profit does not cause the trade or business to be substantially related to an exempt purpose solely on the ground that all of the profits are payable to one or more organizations exempt from taxation under § 501. See § 502. Specifically, the Internal Revenue Service has held that the lease of property under ordinary commercial arrangements does not constitute the exercise of an educational or charitable function in and of itself. Rev. Rul. 58-547, 1958-2 C.B. 275. As such, the operation of Retail Center is unrelated to your exempt purposes and the income generated from the leasing of Retail Center generates unrelated business income.

Although the leasing of Retail Center generates unrelated business income, an exception exists under § 512(b)(3). Section 512(b)(3) excludes from the calculation of unrelated business income all rents from real property. You stated that the income LLC collects from the leasing of Retail Center is income from the rental of real property. You state that LLC contracts with a third-party property management company to conduct the Rental Activities. You state that neither you nor LLC will engage in the Rental Activities directly. These are routine property management and property maintenance services and are not considered the provision of personal services by a landlord to their tenants. See Treas. Reg. 1.512(b)-1(c)(5).

The exception under § 512(b)(3) for income generated from the rental of real property does not apply if the acquisition of real property was debt financed. See § 514(b)(1). However, the inclusion in unrelated business income for income from debt-financed property does not apply for certain "qualified organizations." See § 514(c)(9)(A). The term qualified organization includes organizations described in § 170(b)(1)(A)(ii) and its affiliated organizations described in § 509(a)(3). See § 514(c)(9) (C). Because University is described in § 170(b)(1)(A)(ii) and you are described in § 509(a)(3), both University and you are qualified organizations and the income generated from Retail Center will not be considered unrelated business income. Although the income from Retail Center is not taxable as unrelated business income under § 512(b)(3), it is still income from an unrelated trade or business under § 513.

II. The second issue to be addressed is whether LLC's operation of Retail Center, an unrelated trade or business, will jeopardize your tax-exempt status.

Section 501(c)(3) requires tax-exempt organizations to be operated exclusively for charitable purposes. You have previously received a determination that you have been recognized by the Internal Revenue Service as tax-exempt under § 501(c)(3) and classified as a supporting organization under § 509(a)(3) for providing a broad range of financial support (i.e.,

fundraising, asset administration, investment activities, etc.) to University, which is a college recognized as tax-exempt under § 501(c)(3) and classified as an educational organization under § 170(b)(1)(A)(ii). An organization will jeopardize its tax-exempt status if it is no longer organized or operated for § 501(c)(3) purposes. Because you are the sole member of LLC, the activities of LLC will be attributed to you. As such, you will be deemed to conduct the Rental Activities described above and the operation of Retail Center. As stated above, these activities are unrelated to your exempt purposes other than for your need of income and the use of this income for your charitable purposes.

An organization may continue to meet the requirements of § 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. See Treas. Reg. § 1.501(c)(3)-1(e)(1). The facts of Rev. Rul. 64-182 are substantially similar to those surrounding the acquisition and lease of Retail Center by LLC. The organization in Rev. Rul. 64-182 derived its income principally from the rental of space in a commercial office building that the organization owned and maintained and operated. The charitable purpose of the organization was carried out by aiding other charitable organizations through contributions and grants to those organizations for charitable purposes. In Rev. Rul. 64-182, the organization was deemed to meet the primary purpose test of Treas. Reg. § 1.501(c)(3)-1(e)(1) and to be entitled to exemption under § 501(c)(3) upon a showing that the organization's program of contributions and grants was commensurate in scope with the organization's financial resources. Accordingly, you too should be deemed to meet the primary purpose test and continue to qualify for exemption under § 501(c)(3) as long as your program of supporting University is commensurate in scope with your financial resources.

Your charitable purpose is to provide a broad range of financial support (i.e., fundraising, asset administration, investment activities, etc.) for University. Through LLC, you acquired and manage Retail Center and perform Rental Activities. You affirm that the acquisition of Retail Center did not diminish the size and scope or alter the nature of your charitable program. Other than the debt service expenditures and management service fees paid, you expect your expenditures on behalf of University after the acquisition of Retail Center to be substantially similar to your expenditures on behalf of University prior to the acquisition. Review of your financial statements, including your filed Form 990s, shows that prior to the acquisition you conducted a robust charitable program in regard to your annual support of University. You further affirm that, ultimately, one hundred percent of the net profits from the Retail Center will be contributed to University or its endowment or otherwise expended on University's behalf. Accordingly, your "primary purpose" as used in Treas. Reg. § 1.501(c)(3)-1(e)(1) is to engage in a charitable program on behalf of University and the scope of this charitable program is commensurate in scope with your financial resources. Therefore, you are not organized and operated for the primary purpose of carrying on an unrelated trade or business.

III. The third issue to be addressed is whether the LLC's Rental Activities will cause you to be classified as a feeder organization under § 502. Section 502(a) provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under § 501 on the ground that all of its profits are payable to one or more

organizations exempt from taxation under § 501. In determining the primary purpose of an organization, all circumstances must be considered, including the size and extent of the trade or business and the size and extent of the organization's exempt activities. Treas. Reg. § 1.502-1(a). However, § 502(b)(1) provides that the term "trade or business" shall not include the deriving of rents which would be excluded under § 512(b)(3), if § 512 applied to the organization. Section 512(b)(3) generally excludes rents from real property, subject to a couple of exceptions. In this case, none of those exceptions apply. Accordingly, if § 512 applied, LLC's rental income would be excluded from the calculation of unrelated business taxable income under § 512(b)(3). Therefore, LLC's Rental Activities are not a trade or business within the meaning of § 502, meaning that you will not be classified as a feeder organization under § 502.

CONCLUSION

Based on the foregoing, we rule as follows:

1. The ownership of the Retail Center by LLC and the conduct of Rental Activities on behalf of LLC will not provide a basis for the revocation of your tax-exempt status under § 501(c)(3).
2. Rental payments to LLC by tenants in accordance with the terms of the leases will not be treated as unrelated business taxable income to you.
3. The conduct of the Rental Activities on behalf of LLC and the payment of rent to LLC under the leases will not cause you to be classified as a feeder organization under § 502.

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. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve 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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto
Manager, EO Technical

Enclosure
Notice 437